CASES DECIDED
IN
THE UNITED STATES COURT OF CLAIMS

PART OF OCTOBER, 1975 TO JANUARY 31, 1976

WITH

REPORT OF DECISIONS OF THE SUPREME COURT IN COURT OF CLAIMS CASES

REPORTED BY
AUDREY BERNHARDT
REPORTER

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[2] Entered on duty December 15, 1975.

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DESIGNATION OF A JUDGE OF THE UNITED STATES COURT OF CLAIMS FOR SERVICE IN ANOTHER CIRCUIT

The Chief Justice of the United States, the Honorable Warren E. Burger, pursuant to the authority vested in him by Title 28, United States Code, designated and assigned the Honorable Philip Nichols, Jr., a Judge of the United States Court of Claims, to act as a Circuit Judge of the United States Court of Appeals for the Fifth Circuit from November 3 to November 6, 1975, and for such additional time in advance thereof to prepare for the holding of such court or thereafter as may be required to complete unfinished business.

CASES DECIDED
IN
THE UNITED STATES COURT OF CLAIMS

Part of October 1975 to January 31, 1976 and other cases not heretofore published

524 F. 2d 1343

UNION PACIFIC RAILROAD COMPANY, INC. v. THE UNITED STATES

[No. 310-62. Decided October 22, 1975. Plaintiff's motion for rehearing denied February 27, 1976.]

ON THE PROOFS

Taxes; excess profits tax; excess profits credits; equity invested capital; minimum rule accounting; payroll taxes on vacation pay accounting; effect of corporate distributions on earnings and profits; admissible v. inadmissible assets; readjustment of tax between years; change in book entries; bond discount, expenses and call premiums; donations and grants; burden of proof re refund claim and setoff defense; valuation of corporate stock; valuation date; fair market value.—Plaintiff brought suit in 1962 for refund of income and excess profits taxes for 1942, plus interest. Certain claims have been disposed of by the court as reported at 182 Ct. Cl. 103, 389 F. 2d 437 (1968) and 185 Ct. Cl. 393, 401 F. 2d 778 (1968), *cert. denied*, 395 U.S. 944 (1969), *motion for recon. denied*, 194 Ct. Cl. 1021, *cert denied*, 403 U.S. 931 (1971). Certain counts and defenses relating to "retirement" accounting remain before the trial judge for separate trial. In the present proceeding certain counts and defenses have been conceded by agreements of the parties. As to the remaining counts and defenses, the court *holds* that plaintiff is entitled to recover on its refund claim based upon its right to "expense" minimum rule property in its 1942 return (Part I), to recover on its contention that it could include stock of certain leased line subsidiaries in its capital assets (Part V), and with regard to some "donations and grants" given to plaintiff to spur its construction, some of the grants were includible capital assets and some were not as set forth in the opinion (Part X). Plaintiff is not entitled to recover refunds for other allegations since it cannot deduct 1943 payroll taxes in 1942 (Part II), it cannot include certain stock subscription rights in its earnings and

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Syllabus

profits (Part IV), cannot receive interest on a 1948 agreement with the Commissioner of Internal Revenue (Part VI), and may not recover an offset to setoffs claimed by defendant because it cannot include proceeds from certain land sales in its earnings and profits (Part VII). Defendant is entitled to prevail on its defenses that plaintiff erroneously included unamortized bond discount and expense in its total assets (Part VIII), and that plaintiff mistakenly failed to treat other bond discounts and expenses as "interest" (Part IX); and that defendant is entitled to recover an offset based upon its claim that the Commissioner overvalued plaintiff's equity invested capital (Part XI). The court severs and remands for further consideration by the trial judge the question of whether plaintiff is entitled to increase its earnings and profits by $13 million due to certain accounting errors alleged to have occurred in 1900–1907 (Part III). The amount of recoveries will be determined pursuant to Rule 131(c).

Taxes; income tax; accounting methods; Interstate Commerce Commission minimum rule.

[1] The Interstate Commerce Commission rule for accounting by railroads, effective in 1940–1942, providing that items of road and equipment property costing less than $500 could be charged to operating expenses rather than to a capital account, is in accordance with generally accepted accounting principles, is not such that it inhibits the ability of plaintiff's financial statements to clearly reflect income for tax purposes, and constitutes a method of accounting contemplated by Sec. 41 of the 1939 Internal Revenue Code and Treas. Reg. 111. The minimum rule items are not of such nature or character as to constitute permanent improvements or betterments as contemplated by Sec. 24(a) of the Code.

Internal Revenue ⇐ 1331

Taxes; income tax; accounting methods; Interstate Commerce Commission minimum rule.

[2] Where the ratio of minimum rule items to total operating expenses of plaintiff railroad is as minimal in plaintiff's fiscal picture as they were in *Cincinnati, N.O. & Tex. Pac.* v. *United States*, 191 Ct. Cl. 572, 424 F. 2d 563 (1970), plaintiff may account for the items in 1940–1942 pursuant to the Interstate Commerce Commission's minimum rule. Dollar figures, even large ones, are not a showing of substantial tax consequences in a case of this type. Whether an accounting method distorts the reflection of income depends on the whole picture.

Internal Revenue ⇐ 1331

Taxes; income tax; accounting periods; taxable year of deduction; payroll taxes on vacation pay.

[3] A tax not assessed and paid until a following year may nevertheless be deducted in the prior year, if it meets the "all events" test. So long as a liability remains contingent or if the liability has

Syllabus

attached but the amount cannot be reasonably estimated, a business expense deduction is not allowable. Thus, plaintiff, on an accrual and calendar year basis, although allowed by IRS to deduct from its 1942 income the amount of vacation pay earned by its employees in that year and paid to them in 1943, could not deduct from 1942 income the payroll taxes applicable to the vacation pay, which were payable and paid in 1943, since both the fact of liability and the amount of taxes were, as of December 31, 1942 still in doubt.

Internal Revenue ⇐ 577, 692

Taxes; income tax; accounting periods; taxable year of deduction; payroll taxes on vacation pay.

[4] Although the validity of the Commissioner's ruling in I.T. 3956, 1949–1 Cum. Bull. 78, holding that liability for *vacation pay* is not made contingent for purposes of the "all events" test by the possibility that the employee might forfeit his right to a vacation by leaving the employ prior to his scheduled vacation may continue, because the effective date of Rev. Rul. 54–608 revoking I.T. 3956 has been postponed, the rationale of I.T. 3956 should not be extended to deductibility of the subject *payroll taxes on vacation pay* since it could not have been known by the end of December 1942 which employees would remain employed until the beginning of their respective vacations in 1943 or which ones would be or would not be released for vacation in 1943 and to which ones plaintiff would pay allowances in lieu of vacation, and therefore how many would receive more than $300 in combined regular pay and vacation allowances in one calendar month. Liability for payroll tax was thus under the "all events" test not certain or fixed in 1942.

Internal Revenue ⇐ 692

Taxes; income tax; accounting periods; taxable year of deduction; payroll taxes on vacation pay.

[5] Although the IRS allowed plaintiff to deduct from its 1942 income the amount of vacation pay earned by its employees in that year and paid to them in 1943, a deduction for payroll taxes on such vacation pay was not appropriate or necessary in order clearly to reflect plaintiff's income for 1942. The effect on income in any year of the prospective payroll tax may be clearly enough reflected by a reserve for the tax as a contingent liability. The need for such a reserve is not the equivalent of a right to a deduction.

Internal Revenue ⇐ 692

Taxes; income tax; corporate distributions; effect on earnings and profits.

[6] Distributions to a stockholder of rights to subscribe to stock in the issuer corporation are for tax purposes the equivalent of stock dividends. Such a distribution is not subject to tax as a dividend when the stock itself, had it been distributed directly, would not be subject to tax, whether because of the nature of the

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stock dividend or because of a statutory exemption from tax. And a distribution of rights is taxable when distribution of the stock would be taxable, as it was under the 1936 Revenue Act which taxed stock dividends to the extent constitutionally permissible.

Internal Revenue ⇐ 364.1

Taxes; income tax; corporate distributions; effect on earnings and profits; excess profits computation.

[7] Where plaintiff, a stockholder of IC corporation, in 1922, 1923 and 1925 received distributions of rights to subscribe to preferred stock in IC, such distributions were tax-free dividends subject to the bar of Sec. 115(1) of the 1939 Code to their inclusion in the earnings and profits of plaintiff for excess profits purposes because (1) the law applicable to the years in which the distributions were made provided that a stock dividend shall not be subject to tax, and (2) because the distributions occurring before January 1, 1936 had the effect only of reallocating the basis of the stock originally held, as between the old stock and the new stock received in the distributions, pursuant to Sec. 214(e) of the Revenue Act of 1939.

Internal Revenue ⇐ 906

Taxes; excess profits tax; excess profits credits; equity invested capital; admissible v. inadmissible assets; corporate stock.

[8] Under Sec. 720(a)(1)(A) of the 1939 Code, as amended in 1941, an "inadmissible asset" for purposes of invested capital, is stock in corporations except stock which is not a capital asset. Thus, while corporate stock held by a taxpayer entity is presumptively to be considered as a capital asset and as such "inadmissible", where the circumstances are such as make the stock a noncapital asset, it becomes "admissible."

Internal Revenue ⇐ 891

Taxes; excess profits tax; excess profits credits; equity invested capital; admissible v. inadmissible assets; corporate stock; legislative intent.

[9] The legislative purpose in enacting Sec. 720(a)(1)(A), as amended in 1941, was to make a noncapital asset admissible and thereby part of equity invested capital when the income generated by it was includible in a taxpayer's excess profits net income.

Internal Revenue ⇐ 895

Taxes; income tax; capital gains and losses; capital asset; corporate stock.

[10] Stock in corporations held for a business purpose, that is, one intimately related to the taxpayer's normal source of business income, is not a capital asset. Stock not so related, and held for investment purposes, is a capital asset. Thus, where plaintiff-railroad's acquisition of stock in its own subsidiary and its operation thereof under lease were in pursuance of plaintiff's business as a

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railroad and not as an investment or speculation, the stock is a noncapital asset "admissible" for purposes of equity invested capital under Sections 715 and 720 of the 1939 Code, as amended, and the operation of the leased lines was intended to produce excess profits taxable income.

Internal Revenue ⇐ 891

Taxes; income tax; credits against tax; equity invested capital; purchase of corporate stock; "admissible" noncapital asset; double credit.

[11] While the present decision permits the money which plaintiff-railroad invested in a subsidiary to be treated as invested capital (and thus reduce excess profits taxes) twice, once as part of plaintiff's invested capital and again as part of the invested capital of the subsidiary, neither applicable statute nor regulation limits noncapital asset status to the stock on the dealer's shelf.

Internal Revenue ⇐ 895

Taxes; income tax; readjustment of tax between years; claim of right.

[12] Where plaintiff in 1942 transported war material for the Government and accrued and reported the full charges as income in that year, since the charges were received under a claim of right, income for 1942 could not be recomputed to exclude the amount of cutback or refunds of overcharges. Absent an agreement between a taxpayer and the Internal Revenue Service, under normal tax procedures the cutbacks could be treated only as deductions from taxable income in the years in which the cutbacks were paid over to the Government.

Internal Revenue ⇐ 281

Taxes; income tax; readjustment of tax between years; interest.

[13] Where, under the 1948 cutback agreement plaintiff was permitted to allocate the amounts of the cutback to 1942 when the original charges were included in its taxable income rather than 1943–1957 when cutback refunds were made, and where the IRS subsequently determined an underassessment (due to unrelated items of income) which exceeded the overassessment due to the cutbacks, resulting in a new actual underassessment and deficiency, plaintiff is not entitled to interest on the basis not only of general tax law but on the basis of the cutback agreement itself which in para. 3 allowed payment of interest to plaintiff on refunds only to the extent and limited to the amount of interest payable by plaintiff on the deficiencies from the cutback adjustments in the to-be-assessed years of the actual refunds. Furthermore, para. 3 limits interest paid *to* plaintiff, not interest to be paid *by* plaintiff, and since 1948 the burden of continued accrual of interest has been deliberately assumed by plaintiff by its continuation of the practice of deducting the cutback amount from income in the year of

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the cutback though the agreement contemplated deduction in 1942; accordingly, the continued running of plaintiff's liability for interest on the deficiencies yet to be assessed is appropriate.

Internal Revenue ⇐ 280

Pleading and practice; timeliness of presentation of issue.

[14] Contentions and issues raised by plaintiff for the first time in a post-trial reply brief and in newly requested findings of fact 10 months after the date on which proposed findings were due and submitted, are presented too late and the court will not consider them. The disorder of permitting such a step and the consequent prejudice to defendant in not having timely notice are unthinkable.

Courts ⇐ 465

Taxes; income tax; gross income, inclusions in; accumulated earnings and profits for computing excess profits tax; change in book entries.

[15] Where plaintiff between 1898 and 1918 credited on its books sums received from non-railroad land sales to its investment in road equipment account with no credit being made to income or surplus or as an addition to earnings or retained earnings and profits, since this was a deliberate choice of management and accountants over 50 years ago and absent evidence of a basis for the lands sold which could result in provable income, plaintiff may not change its old book entries in order to return items to income and thus to accumulated earnings for purpose of computing excess profits tax. The burden of proof is on plaintiff when it undertakes to show otherwise than is said in its books.

Internal Revenue ⇐ 1331, 2121

Taxes; excess profits tax; excess profits credits; equity invested capital; admissible v. inadmissible assets; unamortized bond discount and expenses.

[16] Where in its tax returns plaintiff systematically annually charged against income a ratable portion of bond discount and expenses over the life of the bonds, the unamortized bond discount and expense remaining in 1940 through 1942 was not an asset for excess profits tax purposes of Secs. 715 and 720 of the 1939 Code (1952). Unamortized bond discount has none of the characteristics of an asset—it is essentially interest, the cost of the capital obtained, and not having been paid is a liability and remains to be expended in the future. Since plaintiff has not shown that the bond issuance expenses here involved were of any different character than those held in *Helvering* v. *Union Pac. R.R.*, 293 U.S. 282 (1934), (commissions paid for marketing discounted bonds) to be as much interest as bond issuance discount, the subject unamortized bond issuance expense must also be regarded as is unamortized bond discount—a non-asset.

Internal Revenue ⇐ 909

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Taxes; income tax; accounting methods; generally

[17] Double entry bookkeeping and its compelled symmetry may not alter the nature or control the tax treatment of financial realities.

Internal Revenue ⇐ 1331

Taxes; excess profits tax; excess profits credits; excess profits net income; interest paid on borrowed capital; amortized and unamortized bond discount and bond expense and call premiums.

[18] Since under 26 U.S.C. § 719(b)(1952) only half of borrowed capital may be included in invested capital for purposes of excess profits tax credit, and under 26 U.S.C. § 711(a)(2)(B)(1952) only half of the interest paid on borrowed capital is allowed to be deducted from excess profits net income for purposes of this tax, where plaintiff and its subsidiaries deducted in full (did not reduce by 50%) a certain sum composed of (a) amortized bond discount and expense in tax years 1940–1942, (b) unamortized bond discount paid out when certain bonds were retired in 1940 at their face value, and (c) a call premium paid in that year on retirement of said bonds, since the court has determined that bond discount is essentially interest, the amounts of bond discount already amortized are to be deducted as interest, as well as unamortized bond expense on bonds reacquired and call premiums payable and paid at such retirement prior to maturity which are no different in principle from amortized bond discount. Call premiums in this case were payable for the privilege of converting a longer term loan to a shorter, the early repayment working no change in the nature of the payment as interest.

Internal Revenue ⇐ 932

Taxes; income tax; contributions to capital; characteristics of contribution.

[19] In determining whether a nonshareholder's contribution to corporate capital is includible in equity invested capital under the 1939 Internal Revenue Code for income tax purposes, the contribution (1) must become a permanent part of the transferee's working capital structure ,(2) may not be compensation, such as a direct payment for a specific quantifiable service provided for the transferor by the transferee, (3) must be bargained for, (4) foreseeably must result in benefit to the transferee in an amount commensurate with its value, and (5) ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect. (*United States* v. *Chicago, Burlington & Quincy R.R.*, 412 U.S. 401 (1971).)

Internal Revenue ⇐ 422

Taxes; excess profits tax; excess profits credits; equity invested capital; contributions to capital; governmental and private donations and grants.

[20] On plaintiff's claim that certain additions to its equity invested capital and that of its subsidiaries, if allowed, would decrease the

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excess profits tax by increasing excess profits credits for years 1940–42, in light of the characteristics of a contribution to capital set out in *United States* v. *Chicago, Burlington & Quincy R.R.*, 412 U.S. 401 (1971), governmental payments for a new grade crossing, relocation or protection of parts of plaintiff's line threatened with flooding by a projected dam, relocation of parts of the line on account of highways, and other miscellaneous transfers involving essentially an exchange of values or payment for a specific quid pro quo which left plaintiff no better off than before, were not contributions to capital. Furthermore payments, such as from a smelter owner for a spur track which was payment for a specific quantifiable service, and from a copper company to reimburse plaintiff for additional expense of operating a relocated line, although private, fall under the rationale of *Chicago, Burlington* and were not contributions to capital. On the other hand, governmental payments for replacement of existing sanitary facilities with new and better ones which plaintiff would have been required to construct out of its capital funds (whether materials or labor), and private payments from a chamber of commerce for a line between two cities in order to provide train service, from a citizens right-of-way committee for purpose of obtaining a more direct outlet for agricultural products and to open up for shipments certain copper mining properties adjacent to the new line, and from a citizens committee to acquire and transfer to plaintiff an inactive railroad line for permanent operation, were capital contributions since the assets transferred were employed in the production of further or additional income.

Internal Revenue ⟸ 905

Taxes; claim for refund; setoff asserted by Government.

[21] The Government may "offset" refunds due a taxpayer by taxes underpaid.

Internal Revenue ⟸ 2050

Taxes; presumptions; Commissioner of Internal Revenue determinations; presumption of correctness.

[22] While the Commissioner's determination of taxes due is entitled to a presumption of correctness, such presumption is not evidence; it disappears in the face of substantive evidence tending to disprove it.

Internal Revenue ⟸ 2121

Taxes; claim for refund; burden of proof; setoff asserted by Government.

[23] A taxpayer suing for refund has the burden of proving that the refund is legally due him, and where defendant counters with an offset claim, allocation of the burden depends on the nature of the offset. In the present case, where plaintiff claims that the Commissioner undervalued its equity investment and, therefore, unduly restricted its excess profits credit for purposes of determining its excess profits tax, and defendant counters with an offset claim that

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the Commissioner had undervalued plaintiff's equity, since both claims involve the same tax return, defendant must come forward with sufficient evidence to show that there is a reasonable basis for its claim and plaintiff has the ultimate burden of proving its claim.

Internal Revenue ⇐ 2134, 2137

Taxes; valuation of assets; equity invested capital.

[24] Valuation of assets for tax purposes is a question of fact, and is at best an inexact science or highly imprecise art. Asset appraisal requires a reasonable or rational approximation rather than exactitude. Primary valuation techniques include actual sale prices, actual or original cost, replacement cost, capitalized income, price-earnings ratios, and comparison with similar property.

Internal Revenue ⇐ 422

Taxes; valuation of assets; fair market value of stock; generally.

[25] Fair market value is the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under a compulsion to buy or sell, and both being reasonably informed as to all relevant facts. Where stock is freely traded in an open, organized market, stock exchange quotations for the valuation date generally provide the best evidence of value. Stock exchange quotations automatically take some cognizance of many valuation factors, such as goodwill, nature of the business and history of the enterprise, economic outlook in general and that of the specific industry in particular, estimate of dividend paying capacity and sales of similar stock. Since the subject reorganization and acquisition stock was acquired by plaintiff in 1898, the stock market provides a black and white unbiased and contemporaneous measure of its value.

Internal Revenue ⇐ 448

Taxes; valuation of assets; fair market value of stock; valuation date; average selling price.

[26] Once the court has established specific valuation dates as to when plaintiff issued each block of railroad reorganization and acquisition stock, the court will adopt, for purposes of determining plaintiff's 1942 excess profits tax, the generally accepted procedure in income tax cases of using the average between high and low stock market prices on the date in question.

Internal Revenue ⇐ 911

Taxes; valuation of corporate stock; valuation date; fair market value; average selling price.

[27] Since applicable Treasury Regulations mandate valuation of stock at the time of issue and the court has determined that it will employ stock market values for the railroad's reorganization preferred and common stock and acquisition stock, where the reorganization stock was issued on January 31, 1898 and reorganization preferred was first traded on February 2, 1898, the latter date is appropriate for rating reorganization preferred, being fairly

contemporaneous with the reorganization. Furthermore, although reorganization common was not traded until February 25, 1898, since the railroad's trust receipts (exchangeable for one share of the railroad's common and a fraction of a share of preferred) were traded in a sizable amount at the time of reorganization, February 2, 1898 is also appropriate for computing the value of reorganization common. As to the acquisition stock issued in blocks over a 10-year period, the court has evidence permitting it to separate the stock into several blocks and identify an average market price for each block.

Internal Revenue ⇐ 911

Taxes; excess profits tax; excess profits credits; equity invested capital; contributions to capital; what constitutes.

[28] Where new railroad stock was issued in exchange for old railroad common, acquisition common and cash, the proper measurement of plaintiff's equity invested capital for excess profits credits purposes is either the value of the stock issued *or* the value of the stock and cash received, but both the stock issued *and* the cash received may not be included in equity since the cash received was a partial payment for the stock issued.

Internal Revenue ⇐ 905

Robert J. Casey, attorney of record, for plaintiff. *Frank E. Barnett*, *Covington Hardee*, *Thomas J. McCoy, Jr.*, *John A. Craig*, *James E. Pratt*, *David J. Sweet*, *Clark, Carr & Ellis*, of counsel.

Theodore D. Peyser, Jr., with whom was *Assistant Attorney General Scott P. Crampton*, for defendant.

Before COWEN, *Chief Judge*, LARAMORE, *Senior Judge*, SKELTON, NICHOLS, KASHIWA, KUNZIG, and BENNETT, *Judges*.

KUNZIG, *Judge*, delivered the opinion of the court:

This income tax refund case comes before the court on appeal from the Trial Division where findings and an opinion were filed November 9, 1973, by Trial Judge David Schwartz, pursuant to Rule 134(h). The court has reviewed his decision on the briefs, exceptions, and oral argument of counsel, finds itself in agreement with major portions of that recommended decision and adopts them, with minor modification, as Parts I–II and IV–X of its opinion. The court also adopts most of the trial judge's findings of fact, but modifies portions deemed proper upon consideration of exceptions by the

parties. We limit our departure essentially to Parts III and XI of this opinion.

In Part I we deal with plaintiff's claim that it had a right to "expense" certain property costing less than $500 ("minimum rule" property) in its 1942 tax return. In Part II we consider the 1942 deductibility of plaintiff's payroll taxes paid in 1943. In Part III we treat the issue of whether plaintiff may return $13 million to income based upon 1900–1907 accounting errors. In Part IV we handle plaintiff's assertion that certain stock subscription rights received could be included in income. In Part V we resolve plaintiff's request to include stock in certain leased line subsidiaries in its capital assets. In Part VI we answer plaintiff's demand for interest on a 1948 agreement with the Internal Revenue Service. In Part VII we respond to plaintiff's plea to include certain land sale proceeds in its earnings and profits. In Part VIII we decide defendant's "additional defense" that plaintiff erroneously included bond discounts and expenses in its total assets. In Part IX we rule on another additional defense that plaintiff failed to treat other bond discounts, and call premiums as interest. In Part X we pass on plaintiff's entitlement to include certain donations and grants in its equity. Finally, in Part XI we determine the correct amount of plaintiff's equity invested capital based on the value of its stock issued for its operating assets.

We find that plaintiff is entitled to recover in Parts I, V and in some sections of Part X. Plaintiff does not prevail in Parts II, IV, VI and VII. We hold for defendant on its offset claims in Parts VIII, IX and XI. Finally, we remand the issue in Part III for reconsideration by the trial judge.

The Union Pacific Railroad Company brings suit pursuant to the Tucker Act (28 U.S.C. § 1491) and the Internal Revenue Code (§ 7422(a), 1954 Code) for a refund of income and excess profits taxes for 1942. Plaintiff has paid over $30 million in income tax and over $7 million in excess profits tax. It seeks a judgment for $13,409,961.46 (consisting of $9,222,801.78 in statutory interest for 1942 and $4,187,159.68 in income and excess profits tax and assessed interest thereon paid for 1942) or such other amount which may be legally refundable for 1942, together with statutory interest thereon.

The extraordinary span of time from 1942 to the filing of suit is accounted for by the following. The taxpayer filed returns in 1943 and made payments of a total of some $42 million in 1943, 1944 and 1946. Between that time and the conclusion of the audit of the returns in 1957, various timely claims for refunds were filed in amounts varying from $7.7 million to $348,000, and various credits, adjustments and refunds were made in amounts ranging from $694,000 to $196.

The audit, begun in 1945, was completed in 1957. One Internal Revenue agent spent over 5,000 hours, or about 630 working days, on the report, almost 1,000 pages long. The major part of the work was the required preparation of the surplus or accumulated earnings and profits accounts for 25 closely related or subsidiary corporations for the 44 years from 1898, the year of the creation of the taxpayer on the reorganization of the old Union Pacific Railroad. These accounts were directly relevant to the invested capital method chosen by plaintiff for reporting its tax under the World War II excess profits tax act (Title II, § 201, Second Revenue Act of 1940, 54 Stat. 975, 26 U.S.C. §§ 710–752 (1940 ed.)). The primary issue is the valuation of the original Union Pacific Railroad system. This and other major issues required the study of voluminous documents and underlying data located at various points in the country. Various other factors contributing to the length of the audit period included the pendency until 1954 of suits, brought by the taxpayer for earlier tax years, affecting some of the issues involved in 1942 tax liability.

The returns were meantime kept open by consents on the part of the taxpayer. Plaintiff did not press for an early submission of the agent's report, for reasons connected with a certain agreement with the Commissioner concerning freight "cutbacks" or rate refunds, discussed below. It is agreed that the consents were voluntary and without any pressure or coercion and that at no time did plaintiff complain to the Internal Revenue Service concerning the time required to complete the audit of its returns.

The audit, completed in 1957, was the basis of a determination in 1959 of a large net overassessment of tax for 1942. On September 16, 1960, after approval of the determination

by the Joint Congressional Committee on Internal Revenue Taxation, a deficiency in excess profits tax for 1942 was satisfied by credits in income tax and a post-war credit, and a total of $7,793,219.55 was refunded or paid to plaintiff, consisting of income tax and declared value excess profits tax for 1942 and statutory interest thereon.

In 1961 plaintiff filed a timely comprehensive claim for refund of $13,409,961.46, together with interest, and on notice of disallowance, the instant suit was timely brought, on September 14, 1962. The petition as first filed contained 27 counts, to which seven counts were added by an amended petition in 1966. In an answer and four amended answers filed in 1966 and 1968 the Government pleaded 22 separate additional defenses.

Aspects of the case have finally been disposed of as follows. On January 19, 1968, the court pursuant to the Government's additional defense 11 dismissed counts 27 through 30 and 32 through 34 as claims for refund, allowing them to remain only as offsets to defendant's setoffs. 182 Ct. Cl. 103, 389 F. 2d 437 (1968), *cert. denied*, 403 U.S. 931 (1971). Summary judgment dismissing counts 29 and 30 was granted in 1968, thus rendering additional defenses 14 and 15 moot. 185 Ct. Cl. 393, 401 F. 2d 778 (1968), *cert. denied*, 395 U.S. 944 (1969), *motion for reconsideration denied*, 194 Ct. Cl. 1021. Counts 7 and 31 and the additional defenses thereto, Nos. 2, 3, 4 and 10, were ordered separately tried, after final adjudication of the remaining issues, by then Trial Commissioner (now Judge of the U.S. Customs Court) Herbert N. Maletz.

The parties have through their able and diligent counsel engaged in extensive and fruitful pretrial proceedings and negotiations. A substantial number of counts and affirmative defenses were in the course of these proceedings conceded by one or the other party, by agreements limited to this proceeding.

Whole counts and additional defenses which have been conceded, by agreements limited to this proceeding, are these: it is conceded that plaintiff is entitled to prevail on counts 1 and 16; it is conceded that plaintiff is not entitled to prevail on counts 3, 10 through 14, and 27 (thus rendering additional defense 5 moot); and it is conceded that the

defendant is not entitled to prevail on additional defenses 12 and 13. Count 28 is entirely disposed of by agreement. A number of partial concessions of counts were also made as to counts 17, 20, 21 and 22 and additional defense 20. Various items in counts 19–25 not agreed upon by the parties are disposed of in other counts.

The pretrial proceedings culminated in a stipulation of facts of approximately 500 pages, over 500 exhibits agreed by the parties to be received in evidence or ruled upon in advance of trial and an exchange before trial of the direct testimony of the experts to be called by the parties on the valuation issue. The case was tried between February 26 and March 6, 1969. Testimony consisted of the cross and redirect examination of the expert witnesses, and testimony by three additional witnesses. Proposed findings of fact, objections to proposed findings of fact and briefs were filed between October 13, 1969 and January 5, 1971, and further memoranda were filed in May and June, 1973.

I. "MINIMUM RULE" ACQUISITIONS

The Interstate Commerce Commission's rules for accounting by railroads, effective in 1940–1942, required that items of road and equipment property costing less than $500 be charged to operating expenses rather than to a capital account. Such a rule, known as the "minimum rule," had been in effect for many years; in 1940 the break point was raised from $100 to $500. The Government challenges the effectiveness for tax purposes of the change in the rule. The contention is that (1) items of property costing between $100 and $500, concededly of a capital nature and having a useful life of longer than a year, are "permanent improvements" under section 24(a)(2) of the 1939 Code, must be capitalized, and only depreciation deducted, and (2) the minimum rule does not constitute a method of accounting under section 41 of the Code. Plaintiff deducted $113,717.84 for such items, and it is this deduction which is in dispute in count 2.

A similar case has been considered by the court and decided in favor of the taxpayer in *Cincinnati, N.O. & Tex. Pac. Ry.* v. *United States*, 191 Ct. Cl. 572, 424 F. 2d 563 (1970). The minimum rule items, the court held, "are not of such na-

ture or character in relation to the plaintiff's business to constitute permanent improvements or betterments as is contemplated by section 24(a)(2)"; further, that the minimum rule treatment of the items was "in accordance with generally accepted accounting principles and is not such that it inhibits the ability of plaintiff's financial statements to clearly reflect income for tax purposes"; and, finally, that "the minimum rule constitutes a method of accounting as contemplated by section 41 and Treas. Reg. 111, § 29.41–3." 191 Ct. Cl. at 587–88, 424 F. 2d at 572–73.

Defendant seeks to distinguish the decision on the ground that the tax consequences there were *de minimis* while here they are substantial. Substantiality is attempted to be shown by pointing to such facts as the excess of the deductions taken by plaintiff pursuant to the minimum rule over the depreciation allowed by the Commissioner, amounting to $109,926 in 1942, $147,017 in 1943, $175,682 in 1944, $171,850 in 1945 and $115,551 in 1946. The total of $720,026 for the 5 years is said to be substantial.

Dollar figures, even large ones, are not a showing of substantial tax consequences in a case of this type. Whether an accounting method distorts the reflection of income must depend on a whole picture. As the court said in *Cincinnati, N.O. & Tex. Pac. Ry.* v. *United States*, *supra*, "[t]he most convincing evidence that the Commissioner has abused his discretion in prohibiting the plaintiff from treating items [in accordance with the minimum rule] . . . is the statistical analysis . . . which indicates the relationship of the quantum of minimum rule expenses to other substantial income and balance sheet figures." 191 Ct. Cl. at 584, 424 F. 2d at 571.

Let us therefore compare the relationships in the instant case with those held by the court not to inhibit the ability of the Cincinnati's financial statements to reflect its income clearly. In 1942 the Cincinnati's total operating expense was $16,291,053; total investment account was $69,391,628; and challenged minimum rule items were $9,688. For plaintiff the comparable figures were $218,307,770, $442,726,752 and $113,718. The ratio of minimum rule items to total investment account for the Cincinnati was thus .00014; for plaintiff it is .00026. The ratio of minimum rule items to total operating

expense for the Cincinnati was .00059; for the plaintiff it is .00052.

The relationships are, therefore, as minimal in plaintiff's fiscal picture as they were in Cincinnati's. There is accordingly no reason not to follow the court's recent decision and affirm the right of the plaintiff to account for the items in question in 1940–1942, pursuant to the ICC's minimum rule.

Plaintiff is entitled to prevail on count 2.[1]

II. PAYROLL TAXES

The dispute, raised by count 4, is over whether the plaintiff, having been permitted by the Commissioner of Internal Revenue to deduct from its 1942 income, as a business expense, the amount of vacation pay earned by plaintiff's employees in that year and paid to them in 1943, should also be permitted to deduct the payroll taxes applicable to the vacation pay, which were payable and paid in 1943. Plaintiff is on the accrual and calendar year basis. The payroll taxes were those imposed by section 1520 of the Internal Revenue Code of 1939, 26 U.S.C. § 1520 (1940)[2] and Section 8(a) of the Railroad Unemployment Insurance Act, ch. 680, 52 Stat. 1094, 1102 (1938), 45 U.S.C. § 358 (1940).[3]

Plaintiff's contentions were apparently not reflected in its tax returns as first filed. In its return for 1942, plaintiff de-

[1] Since plaintiff prevails on count 2, we do not decide plaintiff's alternative claims based on the minimum rule treatment in counts 32 and 33, nor need we consider defendant's contentions in additional defenses 16 and 17 based upon counts 32 and 33.

[2] "§ 1520. *Rate of Tax.*

"In addition to other taxes, every employer shall pay an excise tax, with respect to having individuals in his employ, equal to the following percentages of so much of the compensation as is not in excess of $300 for any calendar month paid by him to any employee for services rendered to him after December 31, 1936 * * *

* * * * *

"(2) With respect to compensation paid to employees for services rendered during the calendar years 1940, 1941, and 1942, the rate shall be 3 per centum;

"(3) With respect to compensation paid to employees for services rendered during the calendar year[s] 1943, 1944, and 1945, the rate shall be 3¼ per centum;

* * * * *

[3] "Sec. 8. (a) Every employer shall pay a contribution, with respect to having employees in his service, equal to 3 per centum of so much of the compensation as is not in excess of $300 for any calendar month payable by him to any employee with respect to employment after June 30, 1939: * * *."

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ducted, as business expenses, $1,103,413.31 in vacation pay earned by its employees in 1941 and paid to them in 1942, and payroll taxes on the vacation pay, in the amount of $64,108.31, paid in 1942. Consistently, on its return for 1943 plaintiff deducted $1,518,624.02 in vacation pay earned by employees in 1942 and paid to them in 1943, and the applicable payroll taxes of $90,358.13, paid in 1943.

During the audit of its 1942 return, the plaintiff claimed, and the Commissioner allowed, a deduction of the entire amount of the vacation pay earned by its employees in 1942, $1,518,624.02. Relying on the allowance, the plaintiff then made a claim for refund on the ground that it was entitled in 1942 to accrue and deduct the payroll taxes on the entire amount of vacation pay whose deduction had been allowed. The claim was actually one for $26,249.82, the difference between $90,358.13, the amount of the payroll tax claimed as a deduction, and the deduction of $64,108.31 taken on the return. The Commissioner denied the claim and count 4 of the petition seeks the $26,249.82 involved.

The question for decision is whether plaintiff may in 1942 accrue and deduct payroll taxes to be paid in 1943 on vacation pay which was earned, accrued and allowed to be deducted in 1942, though not to be paid until 1943. The answer here given is, no. The reasons follow.

A tax not assessed and paid until a following year may nevertheless be deducted in the prior year, if it meets the "all events" test of *United States* v. *Anderson*, 269 U.S. 422 (1926). By that test a deduction may be taken, in advance of assessment, in the year when all the events take place determining liability and fixing the amount of the tax. Thus (*id.* at 441):

> In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books.

The "all events" test has been restated and applied many times, often in cases similar to the instant case. *E.g.*, *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, 385, n.5 (1961); *Clevite Corp.* v. *United States*, 181 Ct. Cl. 652, 658, 386 F. 2d 841, 843 (1967); *Denver & Rio Grande Western Railroad Co.* v. *Commissioner*, 38 T.C. 557, 572 (1962); *Turtle Wax, Inc.* v. *Commissioner*, 43 T.C. 460, 466–67 (1965). The test is phrased in the current income tax regulations as follows: "Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.461–1(a)(2) (1970), promulgated by T.D. 6282, 1958–1 Cum. Bull. 215, 22 F.R. 10686, Dec. 25, 1957, 26 C.F.R. § 1.461–1(a)(2)(1970).

So long as a liability remains contingent or if the liability has attached but the amount cannot be reasonably estimated, a business expense deduction is not allowed. Treas. Reg. § 1.461–1(a)(2), *supra; Clevite Corp.* v. *United States*, *supra; Texaco-Cities Service Pipe Line Co.* v. *United States*, 170 F. Supp. 644, 645 (1959); *Denver & Rio Grande Western Railroad Co.* v. *Commissioner*, *supra; Turtle Wax, Inc.* v. *Commissioner*, *supra.*

In the instant case, both the fact of liability and the amount of tax were as of December 31, 1942 still in doubt. Uncertainty as to two events as of that date made it impossible then to determine the tax.

One of the facts lacking was knowledge of the total vacation pay which plaintiff's employees would actually receive. Under at least some of plaintiff's labor contracts, the employee forfeited the right to a vacation with pay or to pay in lieu of a vacation, if his employment were terminated, for a reason other than retirement, prior to the time scheduled for his vacation in 1943. Since it could not be known by the end of December of the prior year, 1942, which of plaintiff's employees would remain in its employ until the beginning of their respective vacations in 1943, it could not in 1942 be determined how much vacation pay plaintiff would be required to pay and, therefore, what would be plaintiff's tax liability. The uncertainty would not be resolved until the

time in 1943 of the actual payment of vacation wages or allowances. All events fixing liability not yet having occurred, a deduction in advance, in 1942, is not permitted, under the foregoing authorities, and particularly *Texaco-Cities Service Pipe Line Co.* v. *United States*, *supra*, and *Turtle Wax, Inc.* v. *Commissioner*, *supra*. Compare similar rulings with respect to the excise tax on payrolls of employers other than carriers. G.C.M. 19692, 1938–1 Cum. Bull. 148; Rev. Rul. 69–587, 1969–2 Cum. Bull. 108.

Plaintiff urges that in allowing it to deduct vacation pay earned in 1942, the Commissioner has ruled, pursuant to I.T. 3956, 1949–1 Cum. Bull. 78, that the liability for vacation pay is not made contingent for purposes of the "all events" test by the possibility that the employee might forfeit his right to a vacation by leaving the employ prior to his scheduled vacation. The Government's position on I.T. 3956 is that the ruling was mistaken and has been revoked in Rev. Rul 54–608, 1954–2 Cum. Bull. 8, 9–10; moreover, that it concerned vacation pay and should not be extended to payroll taxes.

In revoking I.T. 3956 the Commissioner ruled "that no accrual of vacation pay can take place until the fact of liability to a specific person has been clearly established and the amount of the liability to each individual is capable of computation with reasonable accuracy." Rev. Rul. 54–608, *supra*. In reaching this decision, the Commissioner relied on three decisions of the Tax Court: *Tennessee Consolidated Coal Co.* v. *Commissioner*, 15 T.C. 424 (1950); *Morrisdale Coal Mining Co.* v. *Commissioner*, 19 T.C. 208 (1952); and *E. H. Sheldon & Co.* v. *Commissioner*, 19 T.C. 481 (1952). In these cases it had been held that liability for payment of vacation pay depended on the condition precedent that the recipient employee be working for the employer-taxpayer on the date required by the contract, and that until that date liability remained uncertain.

The reasoning of Rev. Rul. 54–608 and of the cases it relied upon is preferred over that of I.T. 3956. This court has recently ruled that where "payment of vacation pay * * * is contingent upon employment up to the beginning of the vacation period, a taxpayer cannot accrue expenses for vacation

pay before the taxable year in which the payments are made. Until the vacation period begins, the 'all events' test * * * has not been satisfied." *Clevite Corp.* v. *United States*, *supra*.

Plaintiff urges that the effective date of Rev. Rul. 54–608 has been repeatedly postponed (most recently in Section 903 of the Tax Reform Act of 1969, P.L. 91–172, 83 Stat. 487, 711), and thus that I.T. 3956 is "still the law." The question at hand, however, is not the present effectiveness of I.T. 3956, as governing deductibility of vacation pay by certain classes of taxpayers,[4] but whether its rationale should be extended to the deductibility of payroll taxes on vacation pay. That question is here answered in the negative.

The nature of the payroll tax itself is the source of the second "event" or fact so unknown or uncertain at the close of 1942 as to make the liability contingent and thereby prevent deduction of payroll taxes in that year. The two payroll tax acts (notes 2 and 3, *supra*) subjected to tax only the first $300 of compensation paid to an employee in any calendar month. Under plaintiff's labor contracts, in the event plaintiff could not release an employee for a vacation in 1943, it was obligated to pay the employee an allowance in lieu of the vacation. Where such an allowance was paid in a calendar month in which the employee had already received $300 or more in other compensation, no tax would be due on the excess of $300.

Plaintiff did not know, as of December 31, 1942, which of its employees it would and which it would not be able to release for a vacation in 1943, and to which, therefore, it would pay allowances in lieu of vacation. Unknown, therefore, was how many would receive more than $300, in combined regular pay and vacation allowance, in one calendar month, and thus to what extent the payment of vacation allowances would be free of tax. Liability for the tax was necessarily contingent, until the time of the scheduled vaca-

[4] The postponement of the revocation was intended for those who, in reliance on I.T. 3956, were accruing and deducting vacation pay in the year in which it was earned, and who, in the first year of an effective revocation of I.T. 3956, would be left with no deduction. The postponement is designed to allow time for study and formulation of remedial legislation. *Denver & Rio Grande Western Railroad Co.* v. *Commissioner*, *supra*; S. Rep. No. 91–552, 91st Cong., 1st Sess. 275–77 (1969).

tion in 1943. Only then would it appear how much of the payments to the employee would be liable to tax.

The effect of the $300 maximum on a taxable monthly compensation is confirmed by the facts of plaintiff's actual payments of vacation pay and tax. Plaintiff paid $1,103,413 in vacation pay in 1942. Six percent of this amount—the tax rate in 1942 (notes 2 and 3, *supra*)—is $66,205, yet plaintiff paid payroll taxes of only $64,108. In 1943 plaintiff paid vacation pay of $1,518,624. At 6.25 percent, the tax rate in 1943 (notes 2 and 3, *supra*), it would have paid $94,914, yet plaintiff paid only $90,358. The differences between the amount of the tax payable, if the entire amount of vacation pay were taxable, and the amount of tax actually paid, not explained by plaintiff, can only be attributed to payments of regular pay and vacation allowances in total amounts of over $300 in a month, of which the portion over $300 was free of tax.

Plaintiff contends that the effect of the tax freedom for compensation over $300 in one month is not so great as to disqualify the tax from deductibility because, it is said, plaintiff was able, in 1942, to estimate the amount of tax to be paid with the accuracy required by the "all events" test. Not so. While the amount of a tax may be reasonably estimated and need not be precisely known, liability for the tax must have attached and cannot be approximated or estimated. "[T]he fact that the percentage of items which will be paid can be estimated with reasonable accuracy is not sufficient to support accruals. The individual items must represent fixed liabilities." *Denver & Rio Grande Western Railroad Co.* v. *Commissioner*, *supra*. The accruability test is not whether there is certainty of payment, or if a reasonable estimate can be made, but whether there is certainty of liability. *Trans-California Oil Co., Ltd.*, 37 B.T.A. 119, 127 (1938). Here, liability was not certain or fixed. The effect of the $300 provision was to make the liability for tax uncertain, until the time when the employee actually went on vacation or received both pay and vacation pay. Liability for payroll tax was thus under the "all events" test not certain or fixed in 1942. *Texaco-Cities Service Pipe Line Co.* v. *United States*,

supra; Helvering v. *Russian Finance & Construction Corporation*, 77 F. 2d 324, 327 (2d Cir. 1935).

Lastly, plaintiff urges that since it has been allowed a deduction for vacation pay earned in 1942, a comparable deduction for the tax on such vacation pay is appropriate or necessary in order clearly to reflect its income for 1942. The effect on income in any year of the prospective payroll tax may be clearly enough reflected by a reserve for the tax as a contingent liability. The need for such a reserve is not the equivalent of a right to a deduction. *Lucas* v. *American Code Co.*, 280 U.S. 445, 452 (1930).

Plaintiff is not entitled to prevail on count 4.

III. $13 MILLION DEDUCTIONS

Plaintiff's count 8 also seeks a refund of excess profits taxes based upon an alleged series of accounting errors in 1900–1907. It asserts that certain "betterments and improvements" during these years were "expensed" rather than debited to its investment account. It further contends that in later years, these "betterments" were depreciated and thus "expensed" for a second time. Plaintiff wants to "reverse" this $13 million accounting error by adding it back into accumulated earnings and profits.

The trial judge rejected this claim. He found insufficient proof that the accounting transactions were erroneous, and noted that plaintiff had failed to succeed on this same argument in a case before the Interstate Commerce Commission. 44 ICC Val. Rep. 1, 22 (1933).

The trial judge discredited plaintiff's contention that later depreciation deductions created a "double expensing" of a single item of property. He found that the evidence shows that plaintiff in fact made "*substantial unrecorded retirements*" rather than later retirement deductions. It is this point which troubles the court. The "unrecorded retirement" issues are still before the trial judge. Plaintiff contends that if the court denies its "$13 million" claim for the sole reason that these accounting entries were made to *correct* earlier "retirement errors," and if it is later found that its "retirement" practices were *correct*, plaintiff will have lost the right to alter the "$13 million" entries.

Since the retirement issue is still before the trial judge, the court remands this "$13 million" issue to the trial judge for clarification of the relationship between the retirement issue and the "$13 million" issue. Although it appears that the trial judge rejected plaintiff's claims solely for insufficient proof of a "$13 million" error, we wish to make absolutely certain that his conclusion is not tied to any findings of "erroneous retirement" practices by plaintiff, or that plaintiff was not lured into failure to present proof on the "$13 million" issue because it believed the issue would be tried with the retirement issues.

IV. STOCK SUBSCRIPTION RIGHTS

In each of the years 1922, 1923, and 1925 plaintiff and its wholly owned subsidiary, the Oregon Short Line, both holders of common stock in the Illinois Central Railroad Company, received, as such holders, a distribution of rights to subscribe to Illinois Central convertible preferred stock at $100 per share. The rights were exercised in the year received. At both the time of distribution and exercise, the market value of the stock was higher than the subscription price. The lower of the two aggregate "spreads" between market and distribution prices was some $670,000.

The question presented, determinative in count 15, and determinative in part in other counts, is whether the "spread" at either time was income properly to be included in accumulated earnings and profits of the recipient for excess-profits-tax purposes. The answer, here given in the negative, hinges on the checkered history of the taxation of stock dividends prior to the enactment of the excess profits tax in 1940.

That history begins with the 1918 decision holding the 1913 tax on income inapplicable to a dividend in stock, on the ground that the "proportional interest of each shareholder remains the same" after the receipt of the dividend. *Towne* v. *Eisner*, 245 U.S. 418, 426. In 1916, however, Congress had by statute directed that a "stock dividend shall be considered income, to the amount of its cash value." Section 2(a)(2), Revenue Act of 1916, ch. 463, 39 Stat. 757 (1916). This statute the Supreme Court soon held in violation of the Sixteenth Amendment, in *Eisner* v. *Macomber*, 252 U.S. 189 (1920), on the ground that no income had been received. Though the two

cases had involved simple dividends of common stock to common stockholders, Congress took the decisions as forbidding the taxation as income of any stock dividends, and accordingly provided in the 1921 Act and thereafter, through the 1934 Act, that a "stock dividend shall not be subject to tax." [5]

The premise of this statutory exemption of stock dividends from taxation was upset in 1936 when the Supreme Court decided in *Koshland* v. *Helvering*, 298 U.S. 441, that a dividend in common stock to holders of preferred stock gave rise to income (though not subjected to tax), because the resulting interest of the stockholder was different than before. Now appreciating that *Eisner* v. *Macomber* was not an absolute, and that some stock dividends could be taxable, Congress promptly provided, in the 1936 Act, that dividends in stock or in rights should be taxable to the extent constitutionally permissible.[6] Such taxation as was thereby imposed was to be prospective.[7] These provisions were repeated in the 1939 Code.[8] Under these provisions, such stock dividends as gave rise to income, that is, those that created interests in the recipient different than before, were taxed. See *Helvering* v. *Griffiths*, 318 U.S. 371 (1943); Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, Sec. 5.60 (2d ed.).

Such briefly had been the prior treatment of stock dividends when the excess profits tax was being considered in 1940. Though the change in the taxation of stock dividends in 1936 did not rake up stock dividends of earlier years, the excess profits tax would do so, by its provision that accumulated earnings and profits be an element of equity invested capital. 26 U.S.C. § 718 (1940 ed.). Computation of equity invested capital would require a review and determination of the earnings and profits account of at least some corporate

[5] Section 201(d), Revenue Act of 1921, ch. 136, 42 Stat. 228 (1921); § 201(f), Revenue Act of 1924, ch. 234, 43 Stat. 255 (1924); § 201(f), Revenue Act of 1926, ch. 27, 44 Stat. 11 (1926); § 115(f), Revenue Act of 1928, ch. 852, 45 Stat. 822 (1928); § 115(f), Revenue Act of 1932, ch. 209, 47 Stat. 204 (1932); § 115(f), Revenue Act of 1934, ch. 277, 48 Stat. 712 (1934).

[6] Section 115(f)(1), Revenue Act of 1936, ch. 690, 49 Stat. 1688 (1936):

"A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

[7] Section 1, Revenue Act of 1936, ch. 690, 49 Stat. 1652 (1936).

[8] Section 115(f)(1), 1939 Code, 26 U.S.C. § 115(f)(1) (1940 ed.).

taxpayers from the beginning (one of the causes of the long time spent in auditing the return of the instant plaintiff). On such a review, in the absence of special statutory provision, at least some long-past stock dividends would now by hindsight be understood as having given rise to income and thus includible in earnings and profits, though the dividend had been exempt from tax under the statutes in force between 1921 and 1936.

Special statutory provision was, however, made. Congress dealt explicitly with the effect upon earnings and profits of past, untaxed stock dividends. The draftsmen added to the excess profits tax law a provision that earnings and profits should not be increased by receipt of a dividend, not taxed, whose only effect had been to cause a reallocation of the basis of the old stock to the old and the new stock. This section, quoted in the note,[9] was section 115(1), 1939 Code, 26 U.S.C. § 115(a)(1) (1940 ed.), added by § 501, Second Revenue Act of 1940, ch. 757, 54 Stat. 1004 (1940). Retroactivity was explicit. Section 501(c), Second Revenue Act of 1940, ch. 757, 54 Stat. 1005.[10]

The precise question for present decision is simply whether the distributions of rights to plaintiff and Oregon Short Line were tax-free dividends subject to the bar of § 115(1) to their inclusion in the earnings and profits of the recipient corporation.

The issues are those of construction of § 115(1) and related sections. A first issue is whether the distribution of rights to subscribe to the preferred stock of Illinois Central, the distributing corporation, was a "dividend." It is agreed,

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[9] "Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

"(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

"(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received."

[10] "For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section [§ 501(a), adding § 115(a)(1)] shall be effective as if they were a part of each such Revenue Act on the date of its enactment. * * *"

incidentally, that Illinois Central had sufficient income available for dividends in the amounts involved.

Distributions of rights to subscribe to stock in the issuer, such as are presently involved, are for tax purposes the equivalent of stock dividends. It is settled that a distribution of rights to subscribe to stock is governed by the same rules as determine taxability of the stock itself, had it been directly distributed. *Miles* v. *Safe Deposit Co.*, 259 U.S. 247 (1922); *Choate* v. *Commissioner*, 129 F. 2d 684 (2d Cir., 1942); *Charles M. Cooke, Ltd.* v. *Commissioner*, 2 T.C. 147 (1943). Thus a distribution of rights to subscribe is not subject to tax as a dividend, when the stock itself, had it been distributed directly, would not be subject to tax, whether because of the nature of the stock dividend or because of a statutory exemption from tax. *Miles* v. *Safe Deposit Co.*, *supra*; *Charles M. Cooke, Ltd.* v. *Commissioner*, *supra*.[11] And a distribution of rights is taxable when distribution of the stock would be taxable, as it was under the 1936 Act, which taxed stock dividends to the extent constitutionally permissible. *Choate* v. *Commissioner*, *supra*.

Why, then, was the distribution of rights not a dividend? Plaintiff claims that the transactions in which the rights were distributed were not distributions of dividends but offers to sell corporate property to the corporation's stockholders at less than its value, which on acceptance by the exercise of the rights gave rise to income in the amount of the lesser of the spreads between market and subscription price at the times of distribution and exercise.

Palmer v. *Commissioner*, 302 U.S. 63 (1937) and *Commissioner* v. *Gordon*, 391 U.S. 83 (1968), cited by plaintiff, do support the proposition for which they are invoked—that the sale of corporate property to stockholders at less than its value is as much a distribution of profits subject to tax as income as the formal declaration of a dividend in money. In these cases the property distributed to stockholders was stock in a corporation other than the distributing

[11] Consistently, Article 39 of Treasury Regulations 62, issued under the Revenue Act of 1921, as amended by T.D. 3403, I–2 Cum. Bull. 64 (1922), provided that "Where a corporation issues to its stockholders the right to subscribe to its stock, the value of the right does not constitute taxable income to the stockholder * * *."

corporation. Such stock is when distributed as a dividend no differently treated than is other property. Dividends consisting of stock in the issuing corporation are, however, another matter, subject, as has been seen, to special statutory treatment. The rule governing dividends by offer to sell property is therefore not relevant to the problem at hand. The aspect of that rule, much emphasized by plaintiff, fixing the realization of income at the time of acceptance of the offer as against the time of distribution of the right to buy is as irrelevant as the rule itself.

Accordingly, the criticisms of treatment of the instant distribution as a dividend are invalid. The distributions are dividends within the meaning of § 115(1), if the section is otherwise applicable. The remaining questions have to do with the two conditions for its application stated in § 115(1) (note 8, *supra*).

The first of these is whether the distributions involved were free from tax, for § 115(1) by its terms governs only a distribution "which (under the law applicable to the year in which the distribution was made) was not a taxable dividend." Note 9, *supra*.

The distributions, made in 1922, 1923 and 1925, were in fact not taxed. In the years in question, petitioner and Oregon Short Line, in their consolidated returns, did not include in gross income any amounts as attributable to the receipt of the rights in question. The omission cannot, however, be regarded as a conclusive recognition by the taxpayer that the distributions were not taxable income, for in those years 100 percent of dividends received from domestic corporations were deductible. Section 234(a)(6)(A), Revenue Act of 1921, ch. 136, 42 Stat. 255 (1921); § 234(a)(6)(A), Revenue Act of 1924, ch. 234, 43 Stat. 283 (1924). The text of the applicable statute is, however, clear enough. The law applicable to the distributions is the law in force in the years they took place, 1922, 1923 and 1925. The law in force in each of those years provided that "A stock dividend shall not be subject to tax." Section 201(d) of the 1921 Act and § 201(f) of the 1924 Act, note 5, *supra*. This explicit exemption from taxation fully satisfies the condition of § 115(1) that the distributions have

been tax-free under the law in force at the time they were made.

To dispute this conclusion, plaintiff relies upon *Choate* v. *Commissioner*, *supra*, as holding that the distributions were taxable as income. The reliance is misplaced. *Choate* was a decision under § 115(f) of the 1936 Act (note 6, *supra*). Stock dividends were taxed, as far as constitutionally permissible, both by that Act and by its successor law, the 1939 Code (note 6, *supra*). Both statutes, however, were applicable only prospectively (notes 6, 7, *supra*), and so neither can govern in determining whether the distributions in the 1920's were tax-free.

How clearly *Choate* depends on the prospective change made in the law by § 115(f) appears from this excerpt from the opinion (129 F. 2d at 688):

> In *Miles* v. *Safe Deposit & Trust Co.*, 259 U.S. 247, * * * it was said that rights issued to its common stockholders, to subscribe to a company's unissued common stock, are analogous to stock dividends. Such stock dividends were not constitutionally taxable under *Eisner* v. *Macomber*, 252 U.S. 189 * * *. But under § 115(f) stock dividends are now taxable so far as such a tax is constitutional, and so are rights to the extent that they are dividends. A stock dividend in preferred stock issued to common stockholders is, therefore, now subject to a valid tax.

The second condition for the application of § 115(1) is that the distributions have had the effect only of reallocating the basis of the stock originally held, as between the old stock and the new stock received in the distribution. Before 1936, when stock dividends were not taxed in the belief they were not constitutionally taxable, they were treated by the Treasury as having the effect only of a reallocation of basis as between the old and new stock. The practice was thereafter codified in § 214(e) of the Revenue Act of 1939, ch. 247, 53 Stat. 874 (1939).[12]

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[12] Section 214(e), in pertinent part, provided:

"(e) *Basis Under Prior Acts.*—The following rules shall be applied, for the purposes of the Revenue Act of 1938 or any prior revenue Act, as if such rules were a part of each such Act when it was enacted, in determining the basis of property acquired by a shareholder in a corporation which consists of stock in such corporation, or rights to

The authority for the proposition that the section is a codification of prior Treasury practice is no less than the House Committee which wrote the section. In reporting with approval what became § 214(e), the Committee said (H.R. Rep. No. 2894, 76th Cong., 3d Sess. 42–43 (1940)):

> Tax-free distributions in stock or in rights, whether or not constituting income within the meaning of the sixteenth amendment or exempt to the distributee under section 115(f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act, and tax-free distributions of stock or securities in a corporation a party to a reorganization, have consistently been treated by the Treasury as not resulting upon receipt in an increase in earnings or profits, but as causing the basis of the stock in respect of which the distribution was made to be allocated between such stock and the stock securities received, with the result that earnings or profits are increased, upon the sale of such stock or property, by the entire amount of the recognized gain computed upon the basis so determined by allocation. * * * [The section] explicitly states the rules heretofore applied by the Treasury.

Section 214(e), plaintiff says, cannot be applied, for it is by its terms limited to distributions which are not income (and, plaintiff would go on to say, the distributions here did create income). The portion of the section (note 12, *supra*) relied upon is this: "if the new stock was acquired in a taxable year beginning before January 1, 1936, or acquired in a taxable year beginning after December 31, 1935, and its distribution did not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution." The particular words invoked are: "and its distribution did not constitute income."

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acquire such stock, acquired by him after February 28, 1913, in a distribution by such corporation (hereinafter in this subsection called 'new stock'), or consisting of stock in respect of which such distribution was made (hereinafter in this subsection called 'old stock') if the new stock was acquired in a taxable year beginning before January 1, 1936, or acquired in a taxable year beginning after December 31, 1935, and its distribution did not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution:

> "(1) The basis of the new stock and of the old stock, respectively, shall, in the shareholder's hands, be determined by allocating between the old stock and the new stock the adjusted basis of the old stock; such allocation to be made under regulations which shall be prescribed by the Commissioner with approval of the Secretary."

Plaintiff would read the last clause, beginning with "and," as applicable to acquisitions both "before January 1, 1936" and "after December 31, 1935." Such a reading is erroneous in that it overlooks the disjunctive effect of the "or" which insulates the condition "if the new stock was acquired in a taxable year beginning before January 1, 1936" from the remaining words, including the "and" clause, and leaves the category of acquisitions "before January 1, 1936" unaffected by the conditions placed on the acquisitions "after December 31, 1935." The section embodies a purposeful differentiation, which plaintiff would ignore, between the two stated classes of transfers—1935 and earlier, and 1936 and later. Plaintiff's view, were it accepted, would reduce the clause to a great many unnecessary words and phrases.

The words should rather be taken as if they were punctuated as emphasized in the following: "if the new stock was (*i*) acquired in a taxable year beginning before January 1, 1936, or (*ii*) acquired in a taxable year beginning after December 31, 1935, and its distribution did not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution." Punctuation of this type appears in a successor statute, § 113(a)(19)(A) of the 1939 Code, 26 U.S.C. § 113(a)(19)(A), added by § 214(a) of the Revenue Act of 1939, ch. 247, 53 Stat. 872 (1939). Properly read, the language of the section says that an acquisition before January 1, 1936, alone and without regard to the "and" clause, fulfills the condition for applicability of the section. The "and" clause is applicable only to the words, following the word "or," dealing with acquisitions after December 31, 1935.

Section 214(e), thus being applicable to the acquisitions in 1922, 1923 and 1925, serves to satisfy the second and last disputed condition of § 115(1)—that the dividend have an effect only on allocation of basis.

Accordingly, § 115(1) is operative, and directly forbids the inclusion in a recipient's earnings and profits of the value of the rights distributed in 1922, 1923 and 1925. Plaintiff is not entitled to recover on this issue in count 15 and in all of the counts in which it is raised.

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V. LEASED LINE SUBSIDIARIES

Plaintiff owns all of the stock of the Oregon Short Line Railroad Company, approximately 99 percent of The St. Joseph & Grand Island Railroad Company and (together with Oregon) all of the stock of the Los Angeles & Salt Lake Railroad Company. A large part of the stockholdings was acquired soon after plaintiff's reorganization in 1898 and most of it has been owned by plaintiff for many years. The Oregon Short Line was acquired in exchange for shares in plaintiff whose valuation is the subject of count 5; the stock in the latter two roads cost approximately $8 million.

During 1942 and for several of the years earlier, plaintiff operated substantially all of the properties of these subsidiaries under leases.[13] For practical purposes, the arrangement was a consolidation of railroad operations. Plaintiff paid all of the roads' expenses, including the expenses of maintaining their corporate existence and dividends on the publicly-owned 1 percent of the stock of The St. Joseph & Grand Island, and recorded in its books and reported in its tax returns all the income and expenses of the operations of the lines of the subsidiaries.

Equity invested capital, the basis on which plaintiff computes its excess profits credit, is under the 1939 Code subject to a reduction by the percentage of "inadmissible assets" among total assets. Sections 715, 720, Internal Revenue Code of 1939, 26 U.S.C. §§ 715, 720 (1952 ed.). An "inadmissible asset" is by Section 720(a)(1)(A) of the 1939 Code, as amended in 1941, defined to mean "[s]tock in corporations . . . except stock which is not a capital asset." Admissible assets are by section 720(a)(2) "all assets other than inadmissible assets." That is, while corporate stock held by a taxpayer entity is presumptively to be considered as a capital asset and as such "inadmissible" as an asset for purposes of invested capital, where the circumstances are such as make the stock a noncapital-asset, it becomes "admissible."

[13] The subsidiary-lessors owned some stock which was not subject to the leases; on this stock they may have received some dividends. In the accompanying findings, it is found, at defendant's urging, that the lessors filed tax returns and could have (though they did not) paid dividends to plaintiff. These findings are however not material to the issue presented.

The ultimate question raised by count 18 is therefore whether or not the plaintiff's stock in these subsidiaries is to be treated as an "admissible asset" under Section 720 of the 1939 Code, and thus not be cause for any reduction of the plaintiff's invested capital. Resolution of the question depends on whether the assets are capital assets, which in turn is determined by whether the plaintiff acquired and holds the stock in the lessor roads for a business or for an investment purpose.

The parties are agreed that the legislative purpose was to make a non-capital-asset admissible, and thereby part of equity invested capital, when the income generated by it was includible in a taxpayer's excess profits net income. The simplest illustration of such an asset, prominent in the minds of the drafters of the relevant amendment of the section, is the corporate stock held by a securities dealer for sale to his customers. When such sales take place, there is generated ordinary excess profits net income, the committee reports said, "no different from any other article held for sale by a dealer." H.R. Rep. No. 146, 77th Cong., 1st Sess., 20 (1941); S. Rep. No. 75, 77th Cong., 1st Sess., 20–21 (1941); 87 Cong. Rec., Part 2, 1638 (1941). The regulations thus provide that the term "inadmissible assets" means "stock in all corporations, domestic or foreign, . . . except stock which is not a capital asset (such as stock held primarily for sale to customers by a dealer in securities):" Treasury Regulations 112, Sec. 35.720–1.

Litigation has produced illustrations of non-capital-assets other than the stock on the security dealer's shelf. One is stock in a restaurant, a going business, bought not for investment but to conduct a restaurant business by the use of the corporate assets, there having been some doubt as to the assignability of the lease of the restaurant premises. *John J. Grier Co.* v. *United States*, 328 F. 2d 163 (7th Cir. 1964). Another illustration, one of a number of cases involving stock bought as a source of inventory for regular business, is stock in a distillery, bought by a liquor dealer to obtain rights to purchase whiskey and sold promptly after the rights were exercised. *Western Wine & Liquor Co.* v. *Commissioner*, 18 T.C. 1090 (1952). A relatively recent case in this court in-

volved stock in a manufacturer of yarn, held to be a non-capital-asset because it was bought by the taxpayer, a yarn sales agency, in order to obtain an extremely valuable source of supply of yarn. *Waterman, Largen Co.* v. *United States*, 189 Ct.Cl. 364, 419 F. 2d 845 (1969), *cert. denied*, 400 U.S. 869 (1970). *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298 (1972), does not make *Waterman, Largen* less authoritative.

The rule that emerges from the cases is that corporate stock which is held for a business purpose, that is, one intimately related to the taxpayer's normal source of business income, is not a capital asset. Stock not so related, and held for investment purposes, is a capital asset.

Plaintiff claims that the stock involved here meets the business purpose test for a non-capital-asset, in that plaintiff acquired and has held the stock in these subsidiaries in pursuance of its railroad operations, and not as an investment or speculation; that the operation of the leased lines was intended to produce excess profits taxable income, to be reported in plaintiff's return.

Plaintiff is upheld, and the issue is decided in favor of non-capital-asset status. The result is, however, not free from doubt. It is quite true, as the Government emphasizes, that the case of the securities dealer is far different from that of a leased railroad subsidiary. It is also true that decision in favor of plaintiff permits the money invested in a subsidiary to be treated as invested capital (and thus reduce excess profits taxes) twice, once as part of plaintiff's invested capital and again as part of the invested capital of the subsidiaries. Neither statute nor regulation, however, limits non-capital-asset status to the stock on the dealer's shelf.

The business-purpose-investment-purpose test is at best imprecise. Nuances of the application of the test could doubtless be discussed at length, and a case made for the Government's view, on the basis of the considerations it emphasizes. The consideration which to my mind tips the scales in favor of plaintiff's position is the historical evidence in this case of the intimate relationship of the subsidiaries to plaintiff's success as a railroad system. The loss of its subsidiaries prior to reorganization was a low point in the decline of the old

Union Pacific Railroad, plaintiff's predecessor. The reacquisition of at least the Oregon Short Line was among the first thoughts for the future of the reorganizers and the new management. There can be no doubt that these subsidiary and connecting railroads, led by the Short Line, had great significance for the prosperity of the plaintiff as a transcontinental railroad system, in the years after it came out of reorganization in 1898. This significance appears in the course of the discussion of the valuation of the shares issued in the reorganization for the old road and for the Oregon Short Line, in count 5.

With these origins, the acquisition of the stock cannot be treated as a mere investment unrelated to the business operations of the plaintiff. It was accomplished for an operating, business purpose and the stock was held as part of the operation of plaintiff's business as a railroad. If anything, the leases that followed confirm the conclusion of business and not investment purpose, even assuming that they were entered into only to reduce costs. As different as are a railroad and a restaurant, the case presented is in essence similar to the case of the restaurant stock, *John J. Grier Co.* v. *United States*, *supra*. The plaintiff bought the stock to run the railroad and not to make an investment, and thus the stock is a non-capital-asset "admissible" for purposes of equity invested capital under Sections 715 and 720. *Cf. Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955); *Booth Newspapers, Inc.* v. *United States*, 157 Ct. Cl. 886, 303 F. 2d 916 (1962).

Plaintiff is entitled to prevail on count 18.

VI. INTEREST ON 1948 AGREEMENT

Count 26 makes a claim for interest of over $12 million under a certain 1948 "cutback" agreement between plaintiff and the Commissioner relating to plaintiff's tax liabilities for 1942 and subsequent years. "Cutbacks" are refunds of railroad freight charges which have been paid by the Government. There is little or no dispute as to the facts; only a dispute as to their significance in the light of the agreement.

In transporting war material in 1942, when considerations of secrecy or the novelty of the material made it impossible to determine that a preferential, land-grant rate should be

applied, plaintiff charged the Goverment the full commercial tariff. Thereafter, on audit by the General Accounting Office between 1943 and 1957 (delayed because of the great volume of auditing of wartime charges), the correct rates were determined, and plaintiff refunded the overcharges as they were determined. The refunds of overcharges for 1942 amounted to $12.8 million.

Plaintiff had accrued the full charges made in 1942 as income in that year and reported them as such in its tax return for that year. The charges having been received under a claim of right, income for 1942 could not be recomputed to exclude the amount of the refunds or cutbacks. Under normal tax procedures, the cutbacks could be treated only as deductions from taxable income in the years in which the cutbacks were paid over to the Government. *See Healy* v. *Commissioner*, 345 U.S. 278 (1953); *United States* v. *Lewis*, 340 U.S. 590 (1951). Large amounts of income, reported in years of high, wartime tax rates, were thus, by virtue of the delays in the audit, about to be reversed by reductions in income in postwar years of lower, peacetime tax rates.

In recognition of the prospective inequity, the Commissioner of Internal Revenue and the plaintiff agreed, on November 29, 1948, that normal practice would not be followed—that plaintiff would be permitted to allocate the amounts of the cutbacks not to the years of their payment but to the years in which the original charges had been included in taxable income. Accrued income for 1942, for instance, would be retroactively reduced by the amount of the cutbacks of rates included in income in that year and the cutbacks would be disallowed as reductions in income in the various years—1943 through 1957—in which they were actually made.

The letter from the Commissioner to plaintiff embodying this agreement, called the Cutback Agreement, stated as follows:

> In view of the facts and circumstances presented, permission is granted under the authority conferred in section 43 of the Internal Revenue Code to allocate, on the terms and conditions hereinafter stated, repayments heretofore or hereafter made of excessive transportation charges of the class described above to the years in which such charges were included in taxable income. However,

the allocation of any such repayments of excessive transportation charges to any year shall be made only to the extent the refund or credit of the overpayment of income and/or excess profits tax, if any, resulting therefrom is not prevented for any reason, and the deficiency, if any, of income and/or excess profits tax resulting therefrom may be assessed.

The letter then goes on to set out the "terms and conditions" of the agreement, in numbered paragraphs:

> In this connection, it is understood that you agree, as follows:
>
> 1. All amounts received by you as transportation charges from the Federal Government Departments and Agencies shall be included in taxable income on the accrual basis.
>
> 2. All refunds of transportation charges made by you to the Federal Government shall be allowed as deductions in the year or years in which such transportation charges were included in income, and any deductions claimed in the year or years such refunds were made will be disallowed. * * *

The result of the permitted reduction in income for 1942 and the corresponding increase in income, distributed over 1943–1957, all other things being equal, would be an overpayment of tax for 1942 and underpayments in 1943–1957, and thus a refund for 1942 and deficiencies for 1943–1957. (This would all the more be true if, as seems to have been the case, plaintiff did not in the years following the making of the cutback agreement in 1948 cease its practice, in its tax returns, of reducing its annual income by the respective amounts of cutbacks made in those years.) And interest payable to plaintiff on the refund would exceed interest payable by plaintiff on the deficiencies, by reason of the longer span of time involved in the refund than in the deficiencies.

To relieve the Commissioner of such a net interest liability, the parties further agreed, in the Cutback Agreement, that the maximum interest payable to the plaintiff on a refund caused by the cutbacks should be limited to the amount of interest payable by the plaintiff on the deficiencies caused by the cutbacks, as follows:

> 3. The amount of interest on refunds of income and excess profits taxes resulting from these adjustments

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shall be allowed only to the extent of, and limited to, the amount of interest on deficiencies resulting from these adjustments.

Plaintiff's tax returns for 1942 were, as noted above, not finally audited until 1959. The tax years following 1942 are by reason of waivers still open; deficiencies for these years, resulting from the cutbacks, have thus not been assessed, although they have been disallowed in revenue agents' reports for those years.

Plaintiff filed an excess profits tax return (Form 1121 under the 1939 Internal Revenue Code) for 1942 showing no liability; there followed certain additional payments by plaintiff in anticipation of a deficiency. (The precise amounts, and other details not here necessary, are set out in the accompanying findings of fact.) On audit, and after making general adjustments, the Commissioner computed a deficiency of $15.9 million unrelated to the cutbacks reduction in income.

The cutbacks reduction in income of $12.8 million, alone, would have resulted in an overassessment of $11.3 million. An adjustment attributable to cutbacks therefore required a deduction of $11.3 million from the deficiency of $15.9 million. When this adjustment was made, there remained a total proposed deficiency of $4.6 million, on which $.3 million in interest was payable, or a total assessed deficiency of $4.9 million.

Plaintiff's income and declared value excess profits tax return (Form 1120) showed a tax of $38.4 million. On audit, the Commissioner determined that liability for income tax was $30.4 million and that plaintiff had no liability for declared value excess profits tax. The consequent overassessment of income tax, with adjustments for certain subsequent assessments, was $7.9 million.

The computations for the two taxes were netted out as follows. The deficiency of $4.9 million in excess profits tax was satisfied by a credit of $4.2 million of the $7.9 million overassessment in income tax, and a certain postwar credit of $.7 million. This left $3.7 million due to plaintiff as the net balance of the $7.9 million overassessment of income tax, on which interest of $4 million was payable. The total, $7.7 million, was then paid to plaintiff.

The cutbacks had played a part only in the excess profits tax; the adjustment for cutbacks, the parties are agreed, had no effect on plaintiff's income tax. While the cutbacks of $12.8 million reduced plaintiff's 1942 income subject to income tax by that amount, the effect of the reduction was completely offset by the reduction of an allowable credit, under Section 26 (e) of the Internal Revenue Code of 1939, for income subject to excess profits tax.

There was, also, no connection between the cutbacks and the payment of the deficiency in excess profits tax by credit of a portion of the overassessment of income tax and the interest paid to plaintiff on the refund. It is agreed that the interest of $4.0 million, paid as part of the $7.7 million refunded to plaintiff, was attributable to the overassessment of income tax and was not related to the cutback adjustment or the interest in respect of cutbacks now claimed by plaintiff.

With the apparent complexities created by two tax returns stripped away, and, thereby, the income tax return, the refund of income tax and the interest thereon all set aside, the remaining relevant facts, all related to excess profits tax, are seen to be quite simple. The cutbacks reduced excess profits tax income and had there been no other factors the reduction would have meant an overassessment and a refund of excess profits tax of $11.3 million. Simultaneously, however, other items of income, not in question, increased income by a greater amount, which increase, alone, would have meant a deficiency of $15.9 million. When combined, the two adjustments resulted in a deficiency of $4.6 million. The actual tax liability figures were $18.807 million, on the basis of all adjustments except the cutback adjustment, and $7.484 million on the basis of all adjustments; the difference was the $11.3 million due to cutbacks. This sum was used to reduce the liability otherwise existing. In simplest terms possible, a tentative underassessment of $15.9 million, reduced by a tentative overassessment of $11.3 million due to cutbacks, produced a net actual underassessment and deficiency.

No refund was payable or paid. Since a refund, due to cutbacks or otherwise, was not made, no interest was due or payable. Interest is payable only on a refund. Hence plaintiff can

have no claim to interest, at least on the basis of general tax law.

Plaintiff contends, however, that the Cutback Agreement took the payment of interest in connection with the diminution of income by reason of cutbacks "out of the normal process of assessment and collection," made it "subject solely to the provisions" of the Cutback Agreement, and required the payment of interest on the overassessment of $11.3 million resulting from cutbacks.

The Cutback Agreement does no such thing. It displaces normal rules of assessment, collection and liability for interest on refunds only so far as the terms of the agreement go. And the terms of the agreement have a narrow effect upon interest. Paragraph 3, the only relevant provision of the agreement, does not in any wise provide for or require the payment of interest to plaintiff. It rather sharply limits payments of interest on refunds resulting from cutback adjustments. Interest to plaintiff on refunds resulting from cutbacks, it is provided, "shall be allowed only to the extent of, and limited to" the amount of interest payable by plaintiff on the deficiencies from the cutback adjustments in the to-be-assessed years of the actual refunds.

There is no limit put on the interest payable *by* the plaintiff. That was not the problem deemed needful of any agreement. The problem to which the paragraph is directed is that the large refunds to be expected for the war years, and the long span of time involved, would entail a large liability for interest to be paid by the Commissioner. The parties therefore provided in paragraph 3 that interest should be paid to plaintiff on refunds only in the amount of the interest paid by plaintiff on deficiencies.

The effect is to eliminate any payment of interest to plaintiff on refunds resulting from cutback adjustments. No actual payment of interest could be made *to* plaintiff until the limit on the payment becomes known, and when the limit—the amount of interest payable *by* plaintiff on deficiencies in the subsequent years—does appear, the cross-obligations wash out and nothing is payable to plaintiff.

A more fundamental reason for the failure of plaintiff's claims is that no refund was made and thus no interest was

due, on general principles, unaffected by paragraph 3. Plaintiff seeks to overcome the fact of no refund by arguing that because the agreement required the Commissioner to refund an overassessment by reason of cutbacks, he should therefore not have wiped out the overassessment of $11.3 million resulting from cutbacks. To this plaintiff adds a complaint that its liability for interest on the deficiencies to be assessed for 1943–57 is still running, and that the Commissioner's action has deprived it of a fund of interest with which to minimize its interest bill on the future deficiencies.

Restated to include the relevant facts, the plaintiff's contention is that the agreement requires that interest be paid, as if on a refund, on the tentative overassessment of $11.3 million by reason of one item of income—the reduction in income by the cutbacks—though it was in the final computation wiped out by a larger underassessment of $15.9 million by reason of other items of income. So stated, the lack of merit becomes clear. Interest is payable only on the net, the refund, and not on individual items merged into the net refund. The overassessment of $11.3 million, by reason of the cutbacks, was required to be "wiped out" by the larger underassessment. The Cutback Agreement did not bear on the normal processes of audit and collection. In the paragraph of the agreement preceding the numbered paragraphs, quoted above, there is explicit recognition that the agreed-upon allocation of cutbacks to the year of the original overcharge might result in either "refund or credit." Here it resulted in a credit.

Had the Commissioner not applied the $11.3 million overassessment of excess profits tax resulting from the cutbacks to the $15.9 million deficiency, plaintiff would have been called upon to pay the $15.9 million deficiency resulting from adjustments other than cutbacks, instead of the actual deficiency of $4.6 million. Had plaintiff been granted its wish that it be paid interest for the years since 1943 on the $11.3 million overassessment, it could not have escaped liability for interest on the $15.9 million deficiency. In economic effect, therefore, plaintiff has received the interest on the $11.3 million which it is now claiming.

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Opinion of the Court

Finally, plaintiff complains of the continued running of its liability for interest on the deficiencies yet to be assessed. This is as it must be. The Cutback Agreement shows no sign of an intention to limit plaintiff's liability for interest; paragraph 3 limits interest paid *to* plaintiff, not interest to be paid *by* plaintiff. Interest on a deficiency compensates the Government for the withholding of the money. Since the time of the Cutback Agreement in 1948, the burden of continued accrual of interest has been deliberately assumed by plaintiff, by its continuation of the practice of deducting the cutback amount from income in the year of the cutback, though the agreement contemplated deduction in the year of the original charge. Moreover, plaintiff could stop the running of interest by one method or another, all of which would involve payment.

The claim on the Cutback Agreement has no merit and plaintiff is not entitled to recover on count 26.

VII. 1898–1918 LAND SALES

This count 34 is one of those before the courts as offsets to defendant's setoffs. 182 Ct. Cl. 103, 389 F. 2d 437 (1968). The facts needful to be stated for present purposes are few.

In count 34 a claim is made to include in plaintiff's income, and thus in earnings and profits for excess profits tax purposes, some $23 million received as gross proceeds of sales of land between 1898 and 1918.

The facts are these. Among the properties of its predecessor acquired by plaintiff in the 1898 reorganization were 6,577,000 acres of land in Colorado, Kansas, Nebraska, Wyoming and Utah. By 1919, plaintiff owned only 971,348.64 acres. It cannot be found that the entire difference, 5,604,942.85 acres, was sold, for lack of evidence as to the amount of land acquired in the intervening period, and because the figure for 1919 is one for non-carrier land. A great quantity of land was however sold.

Immediately after the reorganization, plaintiff had transferred the land to the Union Pacific Land Company, which it created for the purpose, in return for the stock and bonds of the Land Company. The bonds—$10 million in par value—were secured by a mortgage on all the Land Company's assets. The Land Company stock and bonds were then pledged by

plaintiff as collateral under the first mortgage on plaintiff's own property.

This last mortgage provided that the net proceeds from sales of non-railroad land were to be paid to plaintiff to reimburse it for expenditures for betterments, improvements and equipment, exclusive of expenditures charged to operating expenses. Accordingly, the trustee paid over to plaintiff, between 1898 and 1918, $23,286,091.13, of his own total receipts of $23,392,717.22. On its books, plaintiff credited the sum received to its investment in road equipment account. No credit was made to income or surplus. The receipt of the money seems to have been simply the occasion for a credit to the investment account, that is, a decrease in the amount shown as invested.

No more is known than is set out above. We can only speculate on why the plaintiff's accountants and management omitted to show on the books as income or surplus the receipt from the trustee of what plaintiff now says was income. In any event, plaintiff did not in whole or in part record the receipt of the $23 million as income or surplus or as an addition to earnings or retained earnings and profits.

In its post-trial brief and requested findings of fact, plaintiff urged, from the foregoing facts (supplemented only by taking it as a fact that 5,604,942.85 acres of land were sold), that the original credit to the investment in road equipment account was error, and that the proceeds of $23,286,091.13 from the sale of 5,604,942.85 acres of land should now be included in its accumulated earnings and profits for excess profits tax purposes. No suggestion was made that a sum less than the $23 million might be earnings and profits; no findings were requested concerning a cost or basis for the lands claimed to have been sold for the $23 million.

In condensed fashion, plaintiff's case was this: land was sold for $23 million, and therefore that sum was income which belonged and belongs in accumulated earnings and profits, whatever the contemporaneous accounting treatment. Of course this is not the law. For one thing, gross proceeds of the sale of land are not gain or income; only the difference between sales price and cost or basis is realized income. Gross

payments on bonds are not income; only the difference between payments and cost is realized income. Section 111, 1939 Code. And this is what the Government replied.

The Government in its reply also pointed out that plaintiff had failed to mention in its proposed findings or brief that $6,972,025.93 of the $23 million—the portion consisting of interest [14]—had already been included by plaintiff in its accumulated earnings and profits for purposes of computation of its excess profits tax, and allowed by the Commissioner, and that this sum could hardly again be claimed.

On this, plaintiff abandoned the claim for $23 million. Admitting that it was entitled to treat as accumulated earnings and profits only the difference between sales price and basis, and admitting that it was not again entitled to the $6.9 million, it now claimed not $23 million, but $5 million. Specifically, it claimed, in newly requested findings proposing figures for each year from 1898 to 1916, that it had sold, for $9,987,507.94, 5,972,197 acres of land which had cost $6,533,664.62, with a realized gain of the difference, $3,453,843.32, and that the Land Company, a "wholly-owned subsidiary," had sold for $9,900,387.23, 3,620,615 acres of land which had cost $8,312,812.83, with a realized gain of the difference, $1,587,574.40. The request for these findings was filed with plaintiff's post-trial reply brief, 10 months after the date on which proposed findings were due and were submitted.

The newly proposed findings contain minutely detailed and varied contentions as to facts and practices over 50 years old.

[14] The stipulated facts on the source of the trustee's receipts and the portion of these receipts represented by the $6.9 million are these:

Source	Amount	Part already included in plaintiff's earnings and profits
(1) Proceeds from sales by plaintiff of land and equipment	$2,381,588.36	----------
(2) Principal of deferred payments, interest thereon, and other receipts from lands of plaintiff less expenses	10,203,367.53	$1,231,264.60
(3) Interest received from U. P. Land Co. with respect to its bonds	5,713,967.20	5,713,967.20
(4) Amounts received from U. P. Land Co. in payment of its bonds	5,067,000.00	----------
(5) Interest on uninvested cash	26,794.13	26,794.13
Total	23,392,717.22	6,972,025.93

Entries on many pages of the books of account of the plaintiff, exhibits whose significance for this purpose had not been mentioned before, were cited to establish cost and sales prices for land parcels said to have been acquired and sold in the years 1898 to 1916.

Only one of the fatal defects in these proposed findings is that so far as can be determined plaintiff did not earlier give defendant notice of such contentions, on trial or in pretrial or at any other time in the many years in which the case had been pending.

In the pleadings, plaintiff had alleged and defendant denied that lands acquired on reorganization were carried on the books at no value and had been disposed of between 1898 and 1919 for $23,286,091.13, which had been erroneously credited to investment in road and equipment and not credited to accumulated earnings and profits. Only the acquisition of lands in the reorganization was admitted.

All the pretrial papers exchanged by the parties—statements by each party of its contentions of law and facts, statements by each party of the controverted facts it proposed to prove and a joint statement of the issues which identified the documents and witnesses with respect to each issue—show on the one hand that plaintiff claimed a zero basis for all the land sold, and on the other hand that defendant never retreated from its denial of the claimed zero basis and from its positions that income is realized only to the extent of the difference between gross receipts and cost, and that plaintiff realized no income from the land transactions beyond the sums (the $6.9 million) already included in accumulated earnings and profits.

These pretrial papers were exchanged and filed as part of extraordinarily extensive pretrial proceedings, which took place under pretrial orders providing that facts, issues and witnesses not proposed, stated or disclosed by a party prior to trial would not be permitted to be proved, raised or called on the trial, except as required by the exigencies of the case. The exigencies of the case most emphatically do not require that plaintiff, having failed in pretrial and trial to mention the facts, contentions and issues it now relies upon, be permitted to raise these issues for the first time after trial, in a

reply brief, long after the time for requested findings has expired.

Plaintiff has until now been committed to a zero basis, which it apparently intended to prove as a matter of law by the arguments and testimony relating to its accounting practices in the opening years of the century concerning retirements of equipment. These were the arguments and testimony which it relied upon in count 8, concerning $13 million deducted from income in those years and credited to investment account. For this position, plaintiff would now substitute a new theory, on new facts, on newly requested findings. It is too late. The disorder of permitting such a step and the consequent prejudice to defendant are unthinkable.

It may be added that even were plaintiff's proposed findings to be considered, they could not be adopted. As might be expected from extemporized findings, the record does not support what plaintiff sets out to prove—the acreage on hand and its cost, the acreage acquired and its cost, and the acreage sold and its proceeds, for plaintiff and the Land Company, for each year from 1898 to 1916. Figures are lacking for major elements in the purported chain of proof; projections and assumptions, offered to fill in the gaps, are hopelessly insufficient. For instance, the proposed figures for gross proceeds are often only contract sale prices, and the lands acquired are often lands surrendered by deferred payment purchasers. Another type of defect is the inconsistency between the new contentions, which ignore the Land Company's bonds, and the earlier position of plaintiff, already imbedded in its tax returns, that this is a case of income from the holding and redemption of bonds.

On the failure of the newly proposed findings, one short statement of this whole affair could be that a basis for the lands sold has not been shown and thus no income is provable. Another is that plaintiff fails to overcome the force of its own books. The crediting of the proceeds to investment in equipment and the failure to credit income and thus add to surplus or earnings or profits, as inexplicable as they may be on looking backwards, were the deliberate choice of plaintiff's management and accountants. As the Interstate Commerce Commission said in connection with the deductions

from income involved in count 8, some purpose must be ascribed to the accountants who made up the books. Plaintiff has the burden of proof when it undertakes to show otherwise than is said in its books. For lack of proof of error or meaninglessness, these entries cannot be undone after they have existed for half a century.

Plaintiff is not entitled to prevail on count 34.[15]

VIII. UNAMORTIZED BOND DISCOUNT AND EXPENSE

When a corporation sells bonds at less than their face value, *e.g.*, 20 year 4 percent bonds with a $1,000,000 face value for $950,000, the difference between the face value and the proceeds, or in the illustration $50,000, is called bond discount. (If the bonds are sold at more than face value the excess is called premium.) The expenses of the issue, say $10,000, which reduce still further the net proceeds of the issue, are called bond expense.

By the customary accounting treatment the $1,000,000 payable at maturity goes on the right or liability side of the corporate balance sheet. The $940,000 net proceeds go into cash, and are recorded on the left or asset side. Where shall the $60,000 in bond discount and expense go? It will have to be paid at maturity, one way or another, and it will have to be defrayed, somehow, from income or capital. One type of treatment is to charge it off immediately against surplus, and this is how plaintiff recorded on its books, presumably in accordance with ICC regulations, the bond discount and expense arising from its sales, in its early years, of bonds at a discount. Another method, the approved income tax treatment, call for a systematic annual charge against income of a ratable portion, over the life of the bonds, and this is what plaintiff did in its tax returns. *Helvering* v. *Union Pacific R.R.*, 293 U.S. 282 (1934).

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[15] With respect to additional defenses 7, 8 and 18, the plaintiff has agreed that, to the extent defendant establishes that certain income was realized subsequent to March 1, 1913, plaintiff withdraws the amounts so established from plaintiff's accumulated earnings and profits. Since such a finding has been made as to the amounts of $375,974.45, $566,431.20 and $13,228.89, whose total is $955,629.54, this latter sum shall be excluded from plaintiff's accumulated earnings and profits, and to this extent defendant is entitled to prevail on additional defenses 7, 8 and 18.

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Opinion of the Court

The question here presented by additional defense is whether unamortized bond discount and expense, remaining in the years 1940 through 1942 after plaintiff's earlier income tax deductions, was correctly treated by plaintiff as an asset for purposes of the excess profits tax, more specifically, for purposes of the reduction in equity invested capital by the percentage of inadmissible assets among total assets, required by sections 715 and 720 of the 1939 Code as amended, 26 U.S.C. §§ 715, 720 (1952).

While the Commissioner of Internal Revenue did not disturb plaintiff's treatment of the sum as an asset, the Government here challenges the propriety of such treatment, in an additional defense, No. 9, by way of a setoff. The amount involved for 1940 through 1942, in excess profits tax credit for 1942 and in credit carryovers from prior years, is $11,526,629, of which $10,355,828 is bond discount and $1,170,801 is bond expense.

The Government is here upheld in its position that unamortized bond discount and expense is not an asset for purposes of the cited sections.

Unamortized bond discount has none of the characteristics of an asset, except for its position on the left side of the ledger. It is essentially interest—the cost to the borrower of the borrowed money or the compensation paid for the use of the borrowed money—and it is to be amortized until maturity of the bonds, and then paid. *Helvering* v. *Union Pacific R.R.*, *supra*. The unamortized portion, interest not yet paid, is patently not an "asset," whatever be the definition of that seldom construed term.[16]

The origins of bond discount determine its character as a reflection of interest rates—real or market and nominal. The corporation which so chooses can simply sell its bonds or other obligations at the market rate of interest and encounter no discount. When, however, an issuer desires to sell bonds which

[16] There is little authority on the definition of assets for purposes of excess profits taxes. It is held that treasury stock is not an asset for purposes of the use of the term in the definition of equity capital in section 437(c) of the Excess Profits Tax Act of 1950, 26 U.S.C. § 437(c) (1952 ed.). *Colt's Manufacturing Co.* v. *Commissioner*, 306 F. 2d 929 (2d Cir. 1962); *Penn-Texas Corporation* v. *United States*, 158 Ct. Cl. 575, 308 F. 2d 575 (1962). And an asset has been described, in the context of the excess profits tax for 1919, as an item valuable and used in the taxpayer's business. *Isbell Porter Co.* v. *Commissioner*, 40 F. 2d 432 (2d Cir. 1930).

will bear on their face a lower rate of interest than that which will cause the bonds to be bought, it perforce must set the price of the bond lower than maturity value. The buyer is offered, in addition to the face rate of interest per annum, the difference between face value and sales price in the form of a lump sum at maturity. This difference is called discount. The yield to the buyer takes two forms—the nominal coupon rate and the deferred lump sum.[17]

Both forms, together called effective interest, are costs to the issuer of the borrowing and compensation to the lender for the loan. Both must be found by the issuer and paid to the lender. Coupon interest is paid annually from income. Discount is accumulated annually (the term "accumulation" is, by accounting authorities, preferred to "amortization"), from income, and paid over at maturity. If the coupon rate, payable annually, is interest, then the lump sum payment, the product of annual accumulation, is also interest.

The income tax treatment of discount—accumulation of the total discount by a charge of a ratable portion against income in each year of the life of the bond—is a recognition of the reality that discount is in essence the same as coupon interest, and that each is a cost of the borrowing to be charged annually against income in the years of the borrowing. The unaccumulated, to-be-charged-against-income interest represented by the remaining years' coupons is of course not an

[17] "Bond discount is defined as the excess of face or maturity value over the amount of cash or equivalent paid in by the original bondholder, and, conversely, premium is defined as the excess of cash paid in over maturity value. The explanation of this excess lies in the fact that, in the discount case, the nominal or 'coupon' rate of interest stated on the bond is less than the market or effective rate. In this case the investor is unwilling to pay maturity value for the bond, since this price would yield only the coupon rate. Instead, the price of the bond is set at some lower point where the yield to the buyer is the same as the market rate of interest on comparable securities. In the case of a premium, the coupon interest rate exceeds the market rate, and the price of the bond is set at a point above maturity value that will yield to the investor only the market rate of interest." R. Wixon, W. G. Kell, & N. M. Bedford, *Accountants' Handbook* (5th ed. 1970) 20.30.

"Authorities generally agree that bond discount should be charged systematically to income as interest expense over the life of the bond issue." *Ibid.*, 20.37.

"Bonds are sold at a discount because the rate of interest specified in the indenture is less than the rate that the issuing company must pay for the use of money. This discount, together with the expense of issue, is customarily charged to unamortized debt discount and expense and written off over the period from the date of issue to the date of maturity of the bonds. The sum of the interest paid and the amortization of debt discount, by periods, represents the effective rate of interest on the outstanding bonds." N. J. Lenhart & P. L. Defliese, *Montgomery's Auditing*, 311 (8th ed. 1957).

asset, and the similarly unaccumulated to-be-charged-portion of effective interest represented by unamortized bond discount is, therefore, equally not an asset. Interest, payable this year or next or to be set aside year by year and paid at a fixed future date, is not an asset.

Judicial, administrative and accounting authority recognize that bond discount is interest. Discount is held to be deferred interest, "likely to arise when the stated rate of interest on the obligation is less than the rate demanded by the market. *American Smelting and Refining Co.* v. *United States*, 130 F. 2d 883 (3d Cir. 1942) * * * [E]conomic and business reality * * * recognizes that to the issuer bond interest is reflected both by the stated rate of interest and by the amount below or above par received by the issuer when the bonds are originally distributed." *Atchison, Topeka and Santa Fe R. Co.* v. *United States*, 443 F. 2d 147, 151, 153 (10th Cir. 1971).

An early, leading decision of the Securities and Exchange Commission held discount to represent "additional interest," "part of the cost which the issuer must eventually pay for the use of the funds." The Commission noted that "[a]ccounting authority recognizes that bond discount should be considered as part of the interest cost of the capital obtained." *In Re Alleghany Corporation*, 6 SEC 960, 962 (1940). The American Institute of Certified Public Accountants, in a 1961 reissue of earlier research bulletins entitled "Unamortized Discount, Issue Cost, and Redemption Premium," is to the same effect.[18]

[18] "1. Until the early days of the century, bond discount was commonly regarded as a capital charge. When the unsoundness of this treatment was recognized, alternative methods of treatment became accepted, under one of which the discount was distributed over the term of the issue, and under the other the discount was charged immediately against surplus, the latter being regarded generally as the preferable course.

"2. Present-day treatment recognizes that on an issue of bonds the amount agreed to be paid (whether nominally as interest or as principal) in excess of the net proceeds constitutes the compensation paid for the use of the money. Where bonds are issued at a discount it is customary to distribute the discount over the term of the bond issue and to charge both the coupon interest and the allocated discount directly to income.

"3. In the committee's opinion it is a sound accounting procedure to treat such discount as a part of the cost of borrowed money to be distributed systematically over the term of the issue and charged in successive annual income accounts of the company. * * *" American Institute of Certified Public Accountants, ACCOUNTING RESEARCH AND TERMINOLOGY BULLETINS (1961) ch. 15, *Unamortized Discount, Issue Cost, and Redemption Premium on Bonds Refunded.*

The attempted characterization of unamortized bond discount as prepaid interest and the likening of it to prepaid insurance or rent is without basis. Discount represents the portion of the face amount of the bonds not received by the debtor, an amount owed and to be paid on maturity. It is more a nonreceipt, an unpaid cost or charge, a liability or a deferred loss, a deficit or an offset to maturity value, than an asset. Prepaid insurance or rent has been paid, could be refunded and will save an expenditure of equal amount in the time to come. Unamortized bond discount has not been paid, is a liability and remains to be expended in the future.[19]

The custom of recording unamortized bond discount on the left side of the balance sheet, even had plaintiff followed it, gives no support to the notion that it is an asset. Expert testimony in the record, made the basis for one of the accompanying findings of fact, is that unamortized bond discount and expense is put on the asset side of the balance sheet "solely to make the balance sheet balance." Double entry bookkeeping and its compelled symmetry may not alter the nature or control the tax treatment of financial realities. *Doyle* v. *Mitchell Brothers Co.*, 247 U.S. 179 (1918); *United Profit-Sharing Corp.* v. *United States*, 66 Ct. Cl. 171, 182 (1928).

Percipient auditors have long recognized that not everything that appears on the left side of the ledger warrants the caption "asset." Robert H. Montgomery, a leading authority, writing that bond discount was not an asset but a deferred loss, attributed its inclusion among assets to the "curse of

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[19] "[The argument t]hat bond discount should be interpreted as prepaid interest and therefore deserves recognition as an asset similar in nature to prepaid insurance or rent * * * has no logical justification. Bond discount, far from being prepaid interest, represents unpaid interest, or that portion of effective interest that will not be paid until the bond matures. No payment of interest has occurred. The issuer has simply borrowed less than the maturity value of the bonds." R. Wixon, W. G. Kell, & N. M. Bedford, *Accountant's Handbook*, *supra* note 17, 20.34.

"Especially objectionable is the practice of labeling discount on bonds or notes—the difference between actual proceeds and the amount due at maturity—as 'prepaid interest,' and this treatment requires further comment. * * * In the case of a loan effected at a discount the borrowing company actually makes no advance or prepayment whatsoever. Far from being 'prepaid' interest the amount of the discount represents *unpaid* or future interest—that portion of the total interest which is not paid until the date of maturity." W. A. Paton, *Advanced Accounting* (1941) 611–12 (emphasis in original).

See also D. J. Dohr, *What Is An Asset*, 73 J. of Accountancy 213, 216–17 (1942).

balancing." Despairing of the acceptance of a realistically unbalanced balance sheet, he suggested changing the balance sheet heading to "Assets etc." and making discount on bonds an "etc." R. H. Montgomery, *The Curse of Balancing, or Theory v. Practice*, 63 J. of Accountancy 279 (1937). Professor W. A. Paton, another authority, concurs in the opinion that bond discount is not an asset.[20]

Plaintiff would support its claim that unamortized bond discount is an asset by the charge-off, on its books, of the entire amount of the discount to surplus, at the time the bonds were first issued. Such accounting for bond discount and expense, while doubtless proper under ICC regulations, is in disfavor with the accounting profession and is not proper tax practice. The profession prefers [21] and the tax law requires

[20] "One of the least excusable of the standard practices of accounting is that which treats bond discount on the issuer's books as an asset either related to such current balances as unexpired insurance and prepaid rent or as a long-term deferred charge allied to organization cost. Unaccumulated discount on a bond or similar security is in no sense an asset, but represents an element of the total 'interest' charged during the life of the contract. The discount is the difference between the amount of the actual capital received from the investor and the par or face value—the amount payable at maturity. It is neither a prepayment of cost by the borrower nor income received in advance by the investor; it is rather that portion of the effective interest which remains unpaid by the corporation and uncollected by the bondholder until the due date of the security." W. A. Paton, *Advanced Acounting, supra* note 19, 608–9.

[21] "The anticipation of this income charge [bond discount] by a debit to income of a previous year or to surplus has in principle no more justification than would a corresponding treatment of coupons due in future years.

"4. The argument advanced in favor of immediately writing off discount was that it extinguished an asset that was only nominal in character and that it resulted in a conservative balance sheet. The weight attached to this argument has steadily diminished, and increasing weight has been given to the arguments that all such charges should be reflected under the proper head in the income account, and that conservatism in the balance sheet is of dubious value if attained at the expense of a lack of conservatism in the income account, which is far more significant." The American Institute of Certified Public Accountants, ACCOUNTING RESEARCH AND TERMINOLOGY BULLETINS (1961) ch. 15, *Unamortized Discount, Issue Cost, and Redemption Premium on Bonds Refunded*, note 16, *supra*.

"If discount on bonds issued is charged directly to income or surplus as a loss the immediate effect is to understate the proprietary equity and the later effect is to free the income statements through the life of the bonds from a portion of the true interest burden. This procedure, accordingly, results in a continuing error, in both statements, from the time the bonds are issued until date of payment." W. A. Paton, *Advanced Accounting, supra* note 19, 610.

"Irregular absorption of discount or premium, such as is permitted under the accounting rules of the Interstate Commerce Commission, is unsatisfactory. Failure to accumulate or to amortize until date of maturity is still more objectionable. If discount is not accumulated until date of payment this means that there has been no recognition of the increase in the bond

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the systematic charge to income over the life of the bonds. The source of both the professional preference and legal requirement for an annual charge to income is the character of bond discount as interest, a cost of borrowing, and the consequent feeling that both types of interest—coupon interest and the discount variety—should equally be reflected in the income account by an annual expense item, else income is overstated. An immediate write-off against earned or paid-in surplus, in effect a charge to past income or to capital, is an over-statement of income by the annual cost of the borrowing. Plaintiff's charge of the entire discount to surplus was thus inconsistent with the nature of discount and cannot give grounds for characterizing it as an asset.

In a final effort to show that discount is an asset, plaintiff urges, with support in the expert testimony given on trial, that the unamortized portion of bond discount would have value to a purchaser of the business, as a source of future tax deductions. Such value is surely limited. Unamortized discount would have no value to a purchaser of the assets, no weight to a lender considering a loan. It has not been bought or paid for, it produces no income and it could not be sold or assigned. The value it might have to a purchaser of the going business, as a source of income tax deductions, could only be realized if profits were made by the use of the admitted assets of the enterprise. That purchase, moreover, would find the same "value" in the obligation to pay the fixed, coupon rate of interest, which like the annual accumulated share of discount, must each year be a charge on income. Discount, actu-

(Continued)

liability from issue price to maturity value—that profits have been overstated because of failure to include accruing discount in interest charges. It then becomes necessary to accrue the entire amount of discount at one stroke by a charge to income or surplus, and if income and surplus are not available in sufficient amount the result is a deficit. Similarly, if premium has not been amortized this means that there has been no recognition of the decreasing liability from issue price to maturity value—that profits have been understated throughout the life of the business by failure to exclude from interest charges the amortization of premium. It then becomes necessary to credit the entire amount of premium to income or surplus in one figure as a belated correction of the proprietary equity." *Ibid.*, 621.

"Under current generally accepted accounting principles, bond discount and expense should be written off over the life of the issue by periodic charges against income. In the past, debt discount and expense was often charged off to earned surplus at the date of issue, or at a later date; this procedure is no longer acceptable." N. J. Lenhart & P. L. Defliese, *Montgomery's Auditing, supra* note 17, 311–12.

ally a cost to be defrayed in the years to come, has the same type of value, as a source of income tax deductions, as the corporation's contracts with its executives, the lease of its premises, its pension plan, or, for that matter, a large tax loss carried over from past years. All give rise to tax savings. Since such "value" does not make an asset of next year's tax loss, it cannot transform unamortized bond discount from unpaid interest to an asset, at least for purposes of an excess profits tax based on concepts of invested capital and total assets.

There remains the unamortized bond expense. It, too, must be regarded as is unamortized bond discount—as a non-asset.

Bond issuance expense may differ factually from bond issuance discount, in that expenses are actually paid out for services such as printing, legal fees and commissions, and, sometimes or always to an extent, are paid out by the issuer itself as distinguished from the issuer's underwriter. Accordingly, some accounting authorities distinguish between discount and expense, and hold the latter to be a genuine asset.[22]

If the question were open for fresh decision, perhaps the unamortized portion of bond expense paid out by the issuer (as distinguished from expenditures for services by underwriters which merely reduce the proceeds of sale paid over to the issuer) might be held to be an asset. Plaintiff has, however, failed to show that the bond issuance expenses here involved were of any different character than those held in

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[22] "It is common practice to lump actual discount with the legal fees, printing costs, underwriting commissions, and other charges associated with the issuing of bonds, but this is not good accounting. The various service costs which must be incurred in raising capital are a genuine asset (not a money fund but a legitimate cost factor) and should be dealt with accordingly. Where such costs are incurred in issuing a terminable security it is reasonable to assume that their significance expires during the life of the security, and complete amortization in this period is therefore indicated." W. A. Paton, *Advanced Accounting*, *supra* note 19, 612.

"Charges connected with the issue of new bonds—such as legal expenses in preparing the bond contract and mortgage, cost of printing certificates, registration costs, commission to underwriters, etc.—are costs of the use of capital obtained for the whole life of the issue and should be written off over that period. * * *

"It is common practice to lump these costs with actual discount (or net them against premium, as the case may be). Good accounting requires careful distinction between a true asset and bond discount, which is properly an offset to the maturity value of the bonds." R. Wixon, W. G. Kell, & N. M. Bedford, *Accountants' Handbook*, *supra* note 19, 20.39.

Helvering v. *Union Pacific R.R. Co.*, *supra*, to be as much interest as bond issuance discount.[23]

In *Helvering* v. *Union Pacific R.R. Co.*, the Supreme Court held that commissions paid out on the issuance of bonds, one of the customary bond issuance costs, were to an accrual taxpayer (as is the instant plaintiff) to be capitalized, amortized over the life of the bond and the amortized amount deducted annually from income. The decision has been applied in this court to bond issuance costs generally. *Chicago, Milwaukee R. Co.* v. *United States*, 186 Ct. Cl. 250, 262, 404 F. 2d 960, 967 (1968).

The Supreme Court in its opinion said that discount and expense were both "factors in arriving at the actual amount of interest paid for the use of capital procured by a bond issue" which "must be added to the aggregate coupon payments in order to arrive at the total interest paid." 293 U.S. at 286. The Court went on as follows (293 U.S. at 286–87):

> But even if the commissions, unlike discount, may, as the Government insists, be regarded as a contemporary expense of procuring capital, it is one properly chargeable to capital account. In practice it is taken out of the proceeds of the bonds by the banker. But in any case it must be deducted from the selling price to arrive at the capital realized by the taxpayer from the sale of the bonds, in return for which he must, at maturity, pay the face value of the bonds. The effect of the transaction in reducing the capital realized, whether through the payment of commissions or the allowance of discount, is the same. * * *
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> Here the commissions, when paid, were properly chargeable against capital, and reduced by their amount the capital realized by the taxpayer from the bond issue. They come out of the pocket of the taxpayer only on payment of the bonds at maturity. But, unlike the purchase and sale of property, the transaction contemplated from the beginning a fixed date, the due date of the bonds, at which the difference between the net amount of capital realized upon the issue and the par value of the bonds must be paid to bondholders by the taxpayer. * * *.

[23] The burden of proof on the issue, though raised by defendant's setoff, is on the plaintiff-taxpayer, for the contested issue is obviously one of substance and is involved in the very tax return on which plaintiff seeks a refund. *Missouri Pacific Railroad Co.* v. *United States*, 168 Ct. Cl. 86, 338 F. 2d 668 (1964).

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Opinion of the Court

Given the Supreme Court's ruling on the essential sameness of discount and expense, albeit in an income tax case, the decision in the instant case can only be that expense goes with discount, and since discount is surely not an asset, expense, too, is not an asset.

Accordingly the defendant is entitled to prevail on additional defense 9.

IX. DISCOUNT AND PREMIUMS

In additional defense 6, also involving bond discount and expense, the Government contends that plaintiff erroneously failed to treat as "interest," under section 711(a)(2)(B) (26 U.S.C. § 711(a)(2)(B) (1952)), amortized bond discount and expense for 1940–42 (excess profits tax credit carryovers for 1940 and 1941 are involved, in addition to 1942 taxes), and call premiums and unamortized bond discount paid out when certain bonds were retired in 1940 at their face value plus a premium, as required by their terms on an early retirement.

Under section 719(b) (26 U.S.C. § 719(b) (1952)) only 50 percent of borrowed capital may be included in invested capital and, consistently, when invested capital is the method used (as it is here) to determine the excess profits credit (which in turn is the basis of the tax), interest deductible from excess profits net income is required by section 711(a)(2)(B), supra, to be reduced by 50 percent of the interest on borrowed capital. In other words, since only half of borrowed capital may be included in invested capital for purposes of the credit, only half of the interest paid on borrowed capital is allowed to be deducted from income for purposes of this tax. See *Amana Refrigeration, Inc.* v. *United States*, 152 Ct. Cl. 406, 410, 285 F. 2d 770, 772 (1961).

Plaintiff and its subsidiaries deducted in full—that is, did not reduce by 50 percent—a certain sum of $10,253,706.34, composed of $546,273.70, the amount of amortized bond discount and expense in the tax years 1940–42, $3,265,051.46, the amount of unamortized bond discount remaining in 1940, the year of the retirement of a certain bond issue, and paid on the retirement, and $6,442,381.18, the call premium paid in that year on the retirement.

In additional defense 6, defendant contends that these deductions were all for "interest" and pursuant to section 711 (a) (2) (B) must be halved. Plaintiff maintains, to the contrary, that amortized discount and the call premiums were ordinary and necessary business expenses under section 23 (a) of the 1939 Code, and that the unamortized bond discount on the bonds reacquired at face value plus call premiums was a loss under section 23 (f) of the 1939 Code.

The regulations provide that on retirement of bonds issued at a discount the excess of the price paid over the issue price plus the amount of discount already deducted is a deductible expense. Treas. Reg. 111, § 29.22(a)–17(3) (1943). The regulations are not helpful in determining whether the amounts are deductible as "interest."

Bond discount has already, in the preceding section of this opinion, been noted to be essentially interest. *Helvering* v. *Union Pacific R.R.*, 293 U.S. 282, 286 (1934). See *Erie Lackawanna R.R.* v. *United States*, 190 Ct. Cl. 682, 686, 422 F. 2d 425, 427–28 (1970). To the seller the difference between the discounted purchase price of a promissory note and the higher sale price is held to be ordinary interest income. *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965). The precise question has been several times decided, in favor of the Government. Discount has repeatedly been held to be interest under section 711(a) (2) (B) or its successor in the Excess Profits Tax Act of 1950, section 433(a) (1) (O), ch. 1199, 64 Stat. 1137, 1143, 26 U.S.C. § 433(a) (1) (O) (1952). *Central Stations Signals, Inc.* v. *Commissioner*, 10 T.C. 1015, 1020–21 (1948), *affirmed per curiam*, 174 F. 2d 479 (2d Cir. 1949) (finance charge for factoring contract held interest under section 711(a) (2) (B) and not expense); *Warner Co.* v. *Commissioner*, 11 T.C. 419, 432 (1948), *affirmed per curiam*, 181 F. 2d 599 (3d Cir. 1950) (amount of state tax on loans, imposed on bond purchaser but paid by issuer in addition to interest, held interest under section 711(a) (2) (B) and not a tax); *L–R Heat Treating Co.* v. *Commissioner*, 28 T.C. 894, 897 (1957) (negotiated bonus for loan withheld by lender from loan proceeds, in addition to 6 percent interest, held interest under 26 U.S.C. § 433(a) (1) (O) (1952 ed.); *Ringmaster, Inc.* v. *Commissioner*, August 6, 1962, T.C. Memo

1962–187, 21 TCM 1024, 1030–32, *dismissed per curiam*, 319 F. 2d 860 (8th Cir., 1963) (amounts paid as commissions for securing loans held interest under § 433(a)(1)(O), not brokerage fees).

The amounts of bond discount already amortized are thus to be deducted as interest. It may well be that an interest expense is also an ordinary and necessary business expense, but it is interest on borrowed capital and thus within the intent and subject to the reach of section 711(a)(2)(B).

Unamortized bond expense on bonds reacquired, and call premiums payable and paid at such retirement prior to maturity, are no different in principle from amortized bond discount. When an issuer sells bonds at a discount, the entire difference between issue price and face value is interest, to be paid at maturity, and to be charged to income each year and accumulated over the life of the bonds. Whether the bonds are early retired, pursuant to the terms of the issuance, by payment of face value plus a call premium, or are retired on maturity by payment of face value alone, there is no distinction to the lender or borrower between the constituent parts of the amount of discount on the loan.

What has been said indicates that call premiums, too, are additional interest, in this case payable for the privilege of converting a longer term loan to a shorter. A payment closely similar to a bond call premium, a charge paid by a borrower when he prepays, before maturity, the principal of a mortgage or promissory note, has been held in this court to be "interest" gross income to an insurance company. In *Equitable Life Assurance Society* v. *United States*, 149 Ct. Cl. 316, 319, 181 F. Supp. 241, 242, *cert. denied*, 364 U.S. 829 (1960), the court held:

> The precise question before us was considered by the Tax Court in *General American Life Insurance Company*, 25 T.C. 1265 (1956). That court decided that prepayment charges are in reality an additional fee for the use of the lender's money for a shorter period of time than originally agreed upon, and that this fee represents the generally higher cost of a short-term, as opposed to a long-term loan. The charges are part of the compensation to the lender for the use of money. *Deputy* v. *duPont*, 308 U.S. 488, 498; *Old Colony R. Co.* v. *Commissioner*, 284 U.S. 552, 560–61. They are thus directly related to the

economic cost of borrowing money and are not merely incidental to the loan transaction, but fall within the statutory term "interest."

See also *The Prudential Insurance Co. of America* v. *United States*, 162 Ct. Cl. 55, 65–66, 319 F. 2d 161, 166–67 (1963); *United Benefit Life Insurance Co.* v. *McCrory*, 242 F. Supp. 845, 850–51 (D.C. Neb., 1965) (penalty payment for early repayment of mortgage held interest income of life insurance company). Contrary dicta in *Central & South West Corp.* v. *Brown*, 249 F. Supp. 787 (D.C. Del., 1965), cannot prevail over the cited authorities.

There would be no rational basis, in the light of the essential sameness of character between discount and call premiums, for holding one to be and the other not to be interest under section 711(a)(2)(B). The sums over the original amount of the loan constitute compensation for the use of the money—interest—payable when the loan is repaid, whether earlier than contemplated or on schedule. The early repayment is for the convenience of the borrower and works no change in the nature of the payment as interest. The decision here is, I believe, all but concluded by the decision of this court that difference between agreed redemption price and issue price (in a case of non-interest-bearing debentures redeemed a year after issue) is income "in lieu of the payment of interest," because it constituted "the agreed compensation for the use of the purchaser's money for the prescribed periods." *Pattiz* v. *United States*, 160 Ct. Cl. 121, 127–28, 311 F. 2d 947, 950 (1963). If part of that difference is a loss, it is a loss which is in the form of additional interest payable for the privilege of early retirement. *Cf. Helvering* v. *Union Pacific R.R.*, 293 U.S. 282, 286 (1934).[24]

Against the foregoing wealth of authority, plaintiff puts forward only inferences from the legislative history of a nearby section, section 711(b)(1)(D), added by section 201

[24] Both commissions and discount, as the Government concedes, are factors in arriving at the actual amount of interest paid for the use of capital procured by a bond issue. The difference between the capital realized by the issue and par value, which is to be paid at maturity, must be added to the aggregate coupon payments in order to arrive at the total interest paid. Both discount and commissions are included in this difference. If the difference be viewed as a loss resulting from the funding operation, it is one which is realized only upon the payment of the bonds at maturity."

of the Second Revenue Act of 1940, ch. 757, 54 Stat. 974, 26 U.S.C. § 711(b)(1)(D) (1952). Section 711(b)(1)(D), not involved in the instant case, disallows certain deductions from taxable income of expenses and losses on the retirement or discharge of bonds, issued at a discount and outstanding for more than 18 months, in computing excess profits income for base period years beginning before January 1, 1940, the computation of which is necessary where the excess profits credit is based on average income rather than invested capital.

The House bill which became section 711(b)(1)(D) read much as does the section in final form, and affected only the computation of excess profits net income for base period years, not here involved. H.R. Rep. No. 2894, 76th Cong., 3d Sess. 13, 14, 19 (1940). The Senate Finance Committee, however, extended the provision to the computation of excess profits net income for the later years as well—the years involved in the instant case—to apply whether income was to be based on either income credit or invested capital method, thereby proposing an amended section 711(a)(2) which had it been enacted would have disallowed "the deduction otherwise allowable under section 23(a) for expenses paid or incurred in connection with such retirement or discharge (including any premium paid upon any such retirement or discharge), the deduction for losses otherwise allowable in such connection, and the deduction otherwise allowable on account of the issuance of the bonds or other evidence of indebtedness at a discount." S. Rep. No. 2114, 76th Cong., 3d Sess. 11–12 (1940). At the same time the committee was in the quoted words speaking of disallowing "expenses" and "losses," plaintiff emphasizes, the committee spoke of "interest" as the subject matter of section 711(a)(2)(B). S. Rep. No. 2114, *supra*, at 12. The conference committee report eliminated the proposed change for all years, retaining it only in section 711(b)(1)(D) for the base years. H.R. Conf. Rep. No. 3002, 76th Cong., 3d Sess. 46 (1940).

Plaintiff would see in the Senate's bill an understanding of Congress that the deductions for amortized bond discount, unamortized bond discount and call premium were expenses and losses rather than interest. In other words, that proposed

change in the law was on the premise that discount and premium were not, as interest, already subject to section 711(a)(2)(B).

The contention aggrandizes an ambiguous legislative incident into the full-blown status of an intent of the whole Congress of material significance on the construction question which is presented. It may be, as plaintiff contends, that the premise and thus the understanding of the framers of the Senate bill was that call premiums and unamortized bond discount were not interest covered by section 711(a)(2)(B). It may also be that though believing that such items, as interest, were subject to section 711(a)(2)(B) and thus to halving only, the draftsmen desired to change the law and achieve a 100 percent disallowance, and thought that section 711(b)(1)(D) was a convenient vehicle because discount and the like were also expenses and losses. We do not know the premise of the Senate bill. We do know that the conference committee rejected the bill as drawn in the Senate, and so whatever was the premise of the Senate bill, it was not Congress' premise.

The conference committee's thinking is equally unknown. Its report gives only the fact of what it did.[25] We do not know if it felt that discount and call premiums were interest, already covered by 711(a)(2)(B), and should not be treated as losses and expenses under section 23, or whether it felt that such items were not interest, but should nevertheless not be disallowed in full. But whatever were the conference committee's views, it cannot be said that it concurred in the version of the Senate's view which squares with the plaintiff's position.

The Senate's view, whatever it was, was surely not the intent of Congress in enacting or construing section 711(a)

[25] The committee said:

"(2) The adjustment requiring that certain deductions otherwise allowable on account of the retirement or discharge of bonds, etc., should be excluded from the computation has been eliminated for taxable years after the base period. As retained relative to taxable years in the base period, it has been redrafted so as to make certain that the excluded deduction on account of the issuance of bonds, etc., at a discount relates only to discount unamortized on the date of the retirement or discharge. The ordinary deduction for amortization of bond discount accrued for that portion of the taxable year preceding the retirement or discharge is not to be excluded from the computation." H.R. Conf. Rep. No. 3002, *supra*, at 46.

(2)(B). The understanding of existing law by one house in the course of legislation, at least in such ambiguous circumstances as are here present, cannot be given effect as the intent of Congress. Too many doubts and questions would surround the result, and as has been said, it is the function of legislative history to resolve doubts and not to create them. The indecisive evidence of legislative intent presented by plaintiff may not gainsay the abundant authority, set out above, supporting the conclusion that amortized bond discount, unamortized bond discount and call premiums paid on retirement of bonds are, all, interest under section 711(a)(2)(B).

The Government is entitled to prevail on additional defense 6.

X. DONATIONS AND CREDITS

By count 17 and related counts, plaintiff seeks to add $3,675,562.72 to its equity invested capital for the year 1942 and $9,798,364.02 and $9,891,701.23 to the equity invested capital of its subsidiaries and itself for the respective years 1940 and 1941, when it filed returns consolidated with its subsidiaries.[26] The additions would decrease plaintiff's tax by increasing its excess profits tax credit for 1942 and its unused consolidated excess profits tax credit carryover from 1940 and 1941 to 1942.[27]

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[26] Counts 17, 21 and 24 directly seek the increase in equity invested capital described in the text. Counts 19, 22 and 25 seek consistent treatment for purposes of computing total assets.

[27] To put the issue in its context, it may be said that the Excess Profits Tax Act of 1940, as amended in 1942, levied a tax of 90 percent (subject to a post-war credit of 10 percent and an overall ceiling of 80 percent on combined income and excess profits tax) on corporate "excess profits net income" remaining after an allowance of an exemption and an excess profits credit representing normal profit. Title II, Second Revenue Act of 1940, as amended, § 710 *et seq.*, 54 Stat. 974, 975, as amended, I.R.C. (1939) as amended, § 710 *et seq.*, 26 U.S.C. (1940 ed. and Supp. II). The taxpayer was given the alternative of computing the credit on the basis either of average income over a base period or (the method chosen by plaintiff) "invested capital."

The Act took a historical approach to the computation of invested capital; it would be composed of "equity invested capital" or the total money and property paid in and left in the corporation (excluding "inadmissible assets" such as stocks and bonds), a prescribed percentage of outstanding borrowed capital and accumulated earnings and profits up to the beginning of the taxable year.

Once invested capital is determined, graduated percentages are applied to determine the excess profits tax credit. The percentages in 1942 were 8 percent of the first $5 million of invested capital, 7 percent of the next $5 million, 6 percent of the next $190 million and 5 percent of amounts over $200 million. The Act was repealed in 1945. 59 Stat. 556, 568.

These sums are the account balances, as of the close of the years in question, representing facilities which were constructed with or composed of the cash and property transferred by nonstockholders to plaintiff and its subsidiaries in literally thousands of "donations and grants" from nonshareholders during the years 1914 through 1942. No income tax was paid on the receipts. They were recorded as assets in the books of plaintiff and its subsidiaries (henceforth, together, called the plaintiff) and were held in the tax years in question for use in plaintiff's trade or business.

The Commissioner of Internal Revenue with a few exceptions disallowed the inclusion of these manifold donations and grants in plaintiff's equity invested capital. Plaintiff challenges the disallowance. In a defense of setoff, the Government challenges the Commissioner's allowance of the inclusion in equity invested capital of six donations and grants.

The parties have by agreement reduced the thousands of transfers involved to 56, to represent all the transfers, and they have also agreed, in the course of their proposals for findings, upon individual transfers to represent the several classes of transfers. These classes are as follows, the amounts stated being those for transfers made prior to January 1, 1940:

Class 1, by far the largest, accounting for $5,992,110 of the $9,798,364 involved, is *governmental transfers to relocate line on account of dams.* It is represented by transactions in which the Federal Government paid the plaintiff the cost of relocating or protecting such parts of its line as would be flooded or threatened by a rise in water level by reason of a Government dam about to be built.

Class 2, $251,669, *governmental transfers to relocate line on account of highways*, is represented by a case in which the City of Long Beach, as part of a plan to build a new highway, by agreement paid the plaintiff $240,000 for the latter's right to operate on certain streets and the right to use, for pedestrian and vehicular traffic, the plaintiff's drawbridge across a harbor entrance.

Classes 3 and 4, $1,947,206, *governmental transfers for highway underpasses and other highway construction*, are

represented by transfers in which a state or city, in the interest of public convenience and safety, and in many cases using federal funds made available for the purpose, paid the cost of railroad highway crossings such as a new grade crossing or the replacement of a viaduct with a highway subway under the railroad's line. These transfers are governed by *United States* v. *Chicago, Burlington & Quincy R.R.*, 412 U.S. 401 (1973), in which substantially identical [28] transfers were held not to effect contributions to capital.

Class 5, $320,601, *governmental miscellaneous transfers*, is divisible as follows: (1) 12 percent is represented by transfers substantially identical with classes 3 and 4; (2) 87.2 percent is represented by payments for fences and street lights on land leased from the plaintiff, cables for utility lines, water mains and irrigation waterways under the right-of-way, and (3) 0.8 percent is represented by a transfer to build sanitary facilities on the plaintiff's premises.

Class 6, $891,354, *private transfers for spur and other tracks*, is represented by several transfers by shippers for the construction of spur tracks to the transferor's plant or installation and two transfers by nonshippers, one identical with those in class 1, *supra*, except that the transferor was a private power company, and the other a railroad with whom plaintiff maintained a joint installation at a highway crossing.

Class 7, $395,422, *private miscellaneous transfers*, is represented by transfers involving payments for street lights on leased property paid for by the lessees; a private road and gates across the right-of-way for the use of, and paid for by, the owner of the land on both sides; feed racks and a scale paid for by a stock yard for its use; a culvert needed and paid for by a water company; a storage facility and a power line for the use of an express company, paid for by it; and a retaining wall needed for a spur track to a shipper's plant, paid for by the shipper.

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[28] It is of no consequence that it does not appear in the instant case, as it did in *Chicago, Burlington & Quincy R.R., supra*, that in all of the transfers the taxpayer railroad assumed a contractual obligation to maintain and repair the facility which was the subject of the transfer. There is every reason to expect that a railroad will in fact maintain, repair and renew the facilities which it owns, in this context typically that portion of a subway structure upon which its track rests or that portion of a grade crossing which it owns.

The issue is whether the facilities built with the cash and property transferred may properly be treated as "money" and "property" "paid in" by nonshareholders "as a contribution to capital," and thus includible in equity invested capital under the 1939 Code.[29] *See* Treasury Regulations 112 § 35.718–1 (1944).

The dispute centers first on classes 1 and 2 of the transfers in question. As noted above, classes 3 and 4 are governed by *Chicago, Burlington & Quincy R.R.*, *supra*, and classes 5–7 are of a miscellaneous nature whose disposition will best be discussed after decision on classes 1 and 2.

In briefs filed before the decision of *Chicago, Burlington & Quincy R.R.*, *supra*, plaintiff contended that the transfers were made to induce the construction and operation of its railroad for the service and safety of the public and were therefore contributions to capital under *Edwards* v. *Cuba R.R.*, 268 U.S. 628 (1925). *See Texas & Pacific Ry.* v. *United States*, 286 U.S. 285 (1932). *Edwards* v. *Cuba R.R.*, *supra*, held that payments of money and property by the Government of Cuba to a railroad corporation, conditioned on the construction of a railroad line—so much per mile—were made as reimbursement for capital expenditures rather than as a gift or to obtain rate concessions and in consequence were not profits or gains taxable as income. The distinctive feature of the transaction was that the Cuban Government was acting deliberately to induce the construction of a railroad, and to promote its success by making a grant towards its capital. The transfers were akin to those made by Congress to the first Union Pacific Railroad, in the Pacific Railway Acts in

[29] "§ 718. Equity invested capital—(a) Definition.

The equity invested capital * * * shall be the sum of the following amounts * * *

(1) Money paid in.

Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) Property paid in.

Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined in the same manner as if the property were still held at the beginning of such taxable year. If such unadjusted basis is a substituted basis it shall be adjusted, with respect to the period before the property was paid in, in the manner provided in section 113(b)(2); * * *"

the last century. Such transfers are utterly unlike those presently in question. *Edwards* v. *Cuba R.R.* is therefore not helpful.

The remaining arguments of the parties are based on *Detroit Edison Co.* v. *Commissioner*, 319 U.S. 98 (1943) and *Brown Shoe Co.* v. *Commissioner*, 339 U.S. 583 (1950), from which the Supreme Court in *Chicago, Burlington & Quincy R.R., supra*, recently distilled a number of the characteristics of a contribution to capital under the Code.[30]

A contribution to capital, the court wrote, "must become a permanent part of the transferee's working capital structure"; it "may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee." It "must be bargained for" (and thus assets granted by a governmental body for replacement of existing facilities, where none otherwise would have been deemed necessary, are not contributions to capital), and the asset transferred "foreseeably must result in benefit to the transferee in an amount commensurate with its value." Finally, "the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect," and thus assets intended for the safety of the public are not contributions to capital, because they were "peripheral to the road's business" and "did not materially contribute to the production of further income by the railroad." 412 U.S. at 413–414.

As already noted, the facts of classes 3 and 4 of the transfers in the instant case are substantially identical with those in *Chicago, Burlington & Quincy R.R., supra*, and thus the

[30] The decision in these cases, involving primarily the issue of depreciability of assets transferred to the taxpayer, turned on whether the asset involved was a contribution to capital, for the income tax act beginning in 1932 provided that the basis of a contribution to capital should be the basis of the transferor, and thus the contribution to capital would be depreciable though having had no cost to the transferee. Section 113(a)(8) as added by the Revenue Act of 1932 c. 209, 47 Stat. 198; I.R.C. 1939, § 113(a)(8). The section confirmed the exemption from income taxation for the class of shareholder contributions, a class broadened by *Edwards* v. *Cuba R.R., supra*, to include the nonshareholder contributions described in the text, *supra*. In the 1954 Code, the former result was changed by a provision for an exclusion from income for all contributions to capital of corporations, with the proviso that the basis of the contribution by a nonshareholder should be zero. §§ 118, 362(c), Int. Rev. Code of 1954.

decision there decides that classes 3 and 4 here are not contributions to capital.

The other classes may be summarily disposed of in the light of the characteristics of a contribution to capital set out in *Chicago, Burlington & Quincy R.R., supra.*

The transfers in class 1, typified by a transfer by the Federal Government to the plaintiff to replace a portion of the right-of-way to be flooded by a projected dam, were matter-of-fact business transactions in which the parties made an equal exchange, without altruism or donative intent. The closest analogy is a condemnation proceeding; no one would contend that payment of a condemnation judgment or of a sum in settlement to avoid an eminent domain proceeding is a contribution to capital. In the words of the majority opinion in *Chicago, Burlington & Quincy R.R., supra*, the transfers in class 1 "simply replaced existing facilities" and "did not materially contribute to the production of further income by the railroad." 412 U.S. at 414.

In *Los Angeles & S.L. R.R.* v. *United States*, 86 Ct. Cl. 87, 21 F. Supp. 347 (1947), a railroad (actually a subsidiary of the present plaintiff) gave up a portion of its line to a mining company in need of the land for an extension of the mine's tailings dumps and received in return a new line as a replacement. This court said that the new line, though costlier than the old, "was of no more use to the railway company than the old line and would not produce a cent more income" or increase the value of the railroad's assets "by a single dollar." 86 Ct. Cl. at 99–100, 21 F. Supp. at 353.

Class 2 transfers are essentially the same as those in class 1 and are equally with class 1 not contributions to capital. Classes 3 and 4, as already noted, are not contributions to capital on the authority of *Chicago, Burlington & Quincy R.R., supra;* 12 percent of the transfers in class 5, found to be essentially the same as the transfers on classes 3 and 4, are also not contributions to capital.

Of the remaining 88 percent of the transfers in class 5, 87.2 percent are represented by these transfers: (1) a state prison, as required by its lease of a portion of the plaintiff's right-of-way for use as a pasture, paid for a "hog-tight" fence for the prison farm; (2) a state paid its share of a

municipal assessment for street lighting on the railroad's grounds at a railroad station, in accordance with the easement contract covering encroachment of the state's highway on the station grounds; (3) a municipal department of power and light paid for the cost of cables for telephone and telegraph lines, to replace open wire lines; the record gives no further details; (4) a town paid for the cost of a water main, under the right-of-way, to the municipal stockyard; (5) and (6) federal irrigation agencies paid for the cost of irrigation waterways under the plaintiff's line.

In all of these it appears that the transfers were essentially an exchange of values or a payment for a specific quid pro quo which left the plaintiff transferee no better off than before and did not materially contribute to the production of further or additional income. Accordingly, under *United States* v. *Chicago, Burlington & Quincy R.R.*, *supra*, the transfers did not effect contributions to the capital of the plaintiff.

The final subgroup of 0.8 percent of the transfers in class 5 is represented by a transfer in 1938 in which a town in Kansas furnished $129 worth of W.P.A. labor to construct four new sanitary privies, notice having been given the railroad by the town to abate the nuisance of unsanitary privies. The scanty record leaves a net impression that in this transfer the town intended, in the interest of the users of the facilities, to confer a benefit upon the railroad, and that the transfer replaced existing facilities with new and better ones which plaintiff would otherwise have been required to construct out of its capital funds and thus that the transfer resulted in a benefit to the transferee in an amount commensurate with its value in that it enabled the plaintiff to avoid a capital expenditure to the value of the assets transferred. The sum whose expenditure was avoided was employed in the production of further or additional income. This group of transfers therefore meets the *Chicago, Burlington & Quincy R.R.* test for a contribution to capital.

The Government maintains that in any event the thing contributed was services, and neither "money" nor "property," as required by § 718 for inclusion in equity invested capital. There is authority that services compensated with

stock are neither "money" nor "property" includible in invested capital. *Bard-Parker Co.* v. *Commissioner* 218 F. 2d 52 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); *Western Maryland Ry.* v. *United States*, 227 F. 2d 576 (4th Cir. 1955), *cert. denied*, 351 U.S. 907 (1956). The more pointed cases, however, albeit decided under an earlier excess profits tax act, recognize that such one-time services as those of architects and engineers which go directly into the creation of a tangible capital asset are so sufficiently reflected in capital assets that their value is includible in invested capital. *Federal Plate Glass Co.* v. *Commissioner*, 6 BTA 351 (1927); *Coatesville Boiler Works* v. *Commissioner*, 9 BTA 1242 (1928); *see Palomar Laundry* v. *Commissioner*, 7 TC 1300 (1946). By the thinking of those cases, the cost of the labor used in building the privy is, as much as the lumber and roofing used, a capital asset and includible in equity invested capital. Money actually passed to workmen who labored to build a structure which became a capital asset. No case holds the cost of such labor not includible in equity invested capital. No principle or policy requires that it be not includible, for the transaction is wholly realistic, without any possibility of exaggeration or evasion. *See Union Pacific R.R.* v. *United States*, 185 Ct. Cl. 393, 401 F. 2d 778 (1968), *cert. denied*, 395 U.S. 944 (1969), *rehearing denied*, 194 Ct. Cl. 1021, *cert. denied*, 403 U.S. 931 (1971).

In the nongovernmental transfers, classes 6 and 7 described above, the transfers were substantially identical to those in class 1 and to the transfers comprising 87.2 percent of the transfers in class 5, or were direct payments for specific things or services. The transfers in those two classes, therefore, are under *Chicago, Burlington & Quincy R.R.*, *supra*, not contributions to capital.

The transfers challenged in the plea of setoff, and the decisions thereon, are as follows:

(1) $200,000 for a spur track to a smelter about to be built, paid for in 1901 by the owner of the smelter; held a payment for a specific quantifiable service and therefore not a capital contribution under *Chicago, Burlington & Quincy R.R.*, *supra*.

(2) $1,076 for railroad line from Orchard, Idaho, to Boise, Idaho, to connect with the existing line from Boise to Nampa, to provide through train service for Boise; paid for in 1925 by the Chamber of Commerce of Boise, Idaho; held this transfer was not a payment for a thing or a service, was bargained for, resulted in benefit to the transferee in an amount commensurate with its value, and the assets transferred were employed in the production of further or additional income. It was therefore a contribution to capital under *Chicago, Burlington & Quincy R.R.*, *supra*, *Brown Shoe* and *Edwards* v. *Cuba R.R.*, *supra*. *See Federated Department Stores* v. *Commissioner*, 426 F. 2d 417, 420 (6th Cir. 1970).

(3) $28,338 for land for a new line from Rogerson, Idaho, to Wells, Nevada, provided in 1925 by a citizens right-of-way committee for the purpose of obtaining a more direct outlet to the California market for Southern Idaho agricultural products, and to open up for tonnage shipments numerous copper mining properties adjacent to the new line. This transfer had the same characteristics as the immediately foregoing transfer and is equally a capital contribution.

(4) $100,000 paid by a citizens committee in 1928 to acquire and transfer to plaintiff a small road which had ceased operations, in consideration of plaintiff's promise to operate it permanently. This transfer was essentially similar to the two foregoing transfers and is equally a capital contribution.

(5) $46,125 paid by the Utah Copper Company to reimburse the plaintiff for the additional expenses of operating a relocated line, in the circumstances detailed in *Los Angeles & S.L.R.R.*, v. *United States*, *supra*. This transfer is held not a capital contribution for the reasons stated above in connection with classes 1 and 2.

(6) $240,421.01 transferred by a citizens committee in 1925. Plaintiff has conceded that defendant is entitled to prevail on this transfer.[31]

XI. EQUITY INVESTED CAPITAL

Plaintiff also seeks a refund of taxes paid on excess profits based on an alleged erroneous determination by the Com-

[31] Thus by agreement and by our opinion, counts 17, 19, 21 and 22 are resolved along with additional defenses 19–22.

missioner of Internal Revenue [Commissioner] of its 1942 equity invested capital credit. Plaintiff contends that the Commissioner *undervalued* its equity investment and, therefore, unduly restricted its credit. In a most unusual counter-attack, defendant also asserts that the Commissioner erred in his equity investment appraisal. However, defendant claims that the Commissioner *overvalued* plaintiff's equity. It, therefore, seeks to "offset" any other refunds due plaintiff.[32] Significantly, neither party supports the Commissioner's determination.

The Excess Profits Tax Act of 1940 grants taxpayers a "credit" for equity invested capital.[33] The Act defines equity invested capital as money and property "paid in" for stock.[34] Where a corporation is organized by issuing stock for property, the property received (invested capital) is valued with reference to the fair market value of the stock issued.[35]

In 1898 plaintiff received the assets of the old bankrupt Union Pacific Railroad [U.P.]. On January 31, 1898, plaintiff issued 610,000 shares of $100 par common stock and 750,000 shares of $100 par, four percent preferred stock. In return, it received the stock of the old U.P. and cash (hereinafter referred to as the reorganization).[36] Later in 1899, plaintiff acquired control of the Oregon Short Line Railroad

[32] The Government may "offset" refunds due plaintiff by taxes underpaid. *Lewis* v. *Reynolds*, 284 U.S. 281 (1932); *Dysart* v. *United States*, 169 Ct. Cl. 276, 283, 340 F. 2d 624, 628 (1965). If defendant can successfully assert its offset based upon excess profits tax credit overdeterminations, he may "scale down" the recovery allowed plaintiff in Parts I and V, *supra*.

[33] INT. REV. CODE OF 1939, § 712.

[34] INT. REV. CODE OF 1939. § 718 provides:

Equity Invested Capital.

(a) Definition.—The equity invested capital for any day of any taxable year * * * shall be the sum of the following amounts, * * *

(1) Money paid in.—Money previously paid in for stock, or as paid in surplus, or as a contribution to capital.

(2) Property paid in.—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (*unadjusted*) for determining loss upon sale or exchange * * *. (Emphasis added)

INT. REV. CODE OF 1939, § 113(a) defines *unadjusted basis* for property acquired. It provides: "The *basis* of property shall be the *cost* of such property." (Emphasis added)

[35] If the taxpayer's basis is cost and stock was issued for the property, then cost is the fair market value of the stock issued for such property at the time of issuance. Treas. Reg. 112, § 35.718–1, Int. Rev. Code of 1939.

[36] The U.P. received one share of old U.P. common and $15 in return for one new share of U.P. common.

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[Oregon] [37] by issuing an additional 273,493 shares of $100 par common for the Oregon common and cash (hereinafter referred to as the acquisition).[38]

Our problem, finding the correct amount of U.P.'s 1942 excess profits tax credit, then resolves into a determination of the value of the U.P. stock issued in these nineteenth century transactions.

In its return for 1942, plaintiff used par values to compute the value of its stock issued for these assets ($163.3 million).[39] The Commissioner disputed this valuation and, at first, attached a value of $122.5 million to the shares. He later modified the stock values to $79.4 million, lowering plaintiff's valuation substantially. Plaintiff paid the 1942 deficiency and filed this refund suit claiming that its original return was correct. In addition to the stock issued, plaintiff also asserted that it was entitled to include the cash contributions received in the reorganization ($9.1 million) and the acquisition ($0.8 million) in its equity invested capital.[40]

Defendant claimed that the value of plaintiff's stock was less than even the Commissioner had determined and asserted an offset against other amounts recoverable by plaintiff. Defendant argued in its pleadings that the fair market value of the U.P. stock was only $57.5 million.

During the trial, plaintiff sought to prove an even greater valuation, and defendant continued to support the value that it had alleged in its pleadings. Plaintiff's valuation expert testified that the proper valuation date for the reorganization stock was January 31, 1898. However, he stated that the true value of the stock must take into account the U.P.'s rapid rise in fortunes during the post-reorganization period. Thus he evaluated the U.P. reorganization and acquisition stock by use of 1907 stock market figures and found

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[37] Actually the U.P. issued the shares over a period of time and gradually acquired common stock of the Oregon. *See* page 77 infra. However, the U.P. acquired control of the Oregon in 1899.

[38] In return for each share of U.P. common stock issued in the acquisition, the U.P. received one share of Oregon common and $3 cash.

[39] Plaintiff contended that its equity invested capital was $61 million for the reorganization common, $75 million for the reorganization preferred, and approximately $27.3 million for the acquisition common—a total equity invested capital of $163.3 million.

[40] *See* notes 36 and 38, *supra*.

values of $175–200 per share for the common and $100 per share for the preferred. His total value estimate was $251.7 million. Defendant's trial expert testified that after considering all valuation techniques,[41] the reorganization common was worth $22.50 per share and the reorganization preferred, $40 per share. Since he rated the acquisition common at $10 million, he assessed plaintiff's total equity invested capital at $57.5 million.

Both plaintiff and defendant contend that the Commissioner's valuation was incorrect and both ask the court to find a per share value for the stock. Significantly, there is absolutely no justification in the record for the Commissioner's valuation since neither party supported it.

The threshold question is whether either party's evidence overcomes the Commissioner's presumption of correctness.

A. *Presumption of Correctness:*

The Commissioner's determination of taxes due is entitled to a presumption of correctness. *Helvering* v. *Taylor*, 293 U.S. 507 (1935); *Northlich, Stolley, Inc.* v. *United States*, 177 Ct. Cl. 435, 442, 368 F. 2d 272 (1966). This presumption applies to excess profits tax credit determinations. *Tri-State Realty Co.* v. *Commissioner*, 180 F. 2d 593 (5th Cir. 1950). However, in our case an unusual situation is presented because neither party supported the Commissioner's determination. Each attempted to assert its own conclusion for asset valuation.

The court believes that there is sufficient evidence in the record to rebut the presumption. Presumptions are not evidence, and they disappear in the face of substantive evidence tending to disprove them. *United Aniline Co.* v. *Commissioner*, 316 F. 2d 701, 704 (1st Cir. 1963); *Kentucky Trust Co.* v. *Glenn*, 217 F. 2d 462, 465 (6th Cir. 1954). Defendant provided sufficient probative evidence of the U.P. value by offering stock market prices for the U.P. stock to rebut the Commissioner's presumption of correctness.

Once we find that the presumption has been rebutted, we must then determine whether either party has met its burden of proof and, therefore, is entitled to a refund or offset.

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[41] Defendant's expert testified on stock market values, net asset values, price-earnings estimates, capitalization of earnings, and comparison of the U.P. stock with similar railroad stocks.

B. *Burden of Proof:*

Where plaintiff sues for a refund he has the burden of proving that the refund is "legally due" him. *Helvering* v. *Taylor*, *supra*; *Lewis* v. *Reynolds*, 284 U.S. 281 (1932). Where defendant counters with an offset claim, allocation of the burden depends on the nature of the offset. If the offset is based upon the same tax return as plaintiff's refund claim, the ultimate burden of proof remains on plaintiff. However, defendant has the burden of "coming forward" with sufficient facts to show that it "has a reasonable basis for its set-off." *Missouri Pacific R.R. Co.* v. *United States*, 168 Ct. Cl. 86, 338 F. 2d 668 (1964). In the instant case, plaintiff has the ultimate burden of proving that the Commissioner undervalued its equity. Since its offset claim involves the same tax return, defendant must "come forward" with sufficient evidence to show that there is a reasonable basis for its claim that the Commissioner overvalued the U.P. stock.

Valuation of assets is a question of fact. *American Steel Foundries* v. *United States*, 153 Ct. Cl. 234 (1961). The question before the court is the value of the U.P. investment. The court may adopt plaintiff's conclusions, may adopt defendant's, or any reasonable value in between. *Toronto, Hamilton & Buffalo Nav. Co.* v. *United States*, 116 Ct. Cl. 184, 207–08, 88 F. Supp. 1016, 1022 (1950). We find from the stock market prices presented by defendant that it has met its burden of coming forward. There is sufficient evidence to find a reasonable basis for defendant's allegation of overvaluation by the Commissioner. We also find that plaintiff has failed to meet its burden of proving that the Commissioner undervalued the investment. We hold that defendant is entitled to an offset.

C. *Equity Valuation:*

Valuation of property is at best an inexact science or highly imprecise art, and there are as many approaches to valuation as there are valuation experts. Asset appraisal, therefore, requires a reasonable or rational approximation rather than exactitude. Primary valuation techniques include actual sale prices, actual or original cost, replacement cost, capitalized income, price-earnings ratios, and comparison with similar property. I *J. Bonbright*, *Valuation* 113–269 (1937). Each

method has its own variations, strengths and weaknesses. We have received evidence of U.P. value based upon stock market prices, net asset values, capitalization of earnings, price-earnings ratios and comparison of the U.P. with similar stock.

While each valuation method has shortcomings, we find sufficient evidence to adduce a reasonably accurate value for U.P.'s reorganization and acquisition stock.

The departure point for our valuation inquiry begins with the proposition that "fair market value is the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both being reasonably informed as to all relevant facts." *Bankers Trust Co.* v. *United States*, 207 Ct. Cl. 422, 437, 518 F. 2d 1210, 1219 (1975); *Jack Daniel Distillery* v. *United States*, 180 Ct. Cl. 308, 315–16, 379 F. 2d 569, 574 (1967). This court has frequently used stock market prices to value stock. As Judge Davis noted in *Bankers Trust*, "Where stock is freely traded in an open, organized market, stock exchange quotations for the valuation date generally provide the best evidence of value." *Bankers Trust Co.*, *supra*, at 437, 518 F. 2d at 1219, citing *Moore-McCormack Lines, Inc.* v. *Commissioner*, 44 T.C. 745, 759 (1965); *Southern Natural Gas Co.* v. *United States*, 188 Ct. Cl. 302, 351–52, 412 F. 2d 1222, 1252 (1969); 10 *J. Mertens, The Law of Federal Income Taxation* §§ 59.13 at 42–43, 59.14 at 47 (1970). The *Bankers Trust* opinion contains an excellent analysis of the situations in which stock market values are not accurate value determinants.[42] We note that such situations are not present in the instant valuation.[43]

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[42] (1) If the market is too thin to absorb the shares offered for sale; (2) if too few sales are made to place any reliance on the validity of the prices commanded; (3) if restricted stock is sold; (4) if an agreement not to resell exists; (5) if so many shares are sold that supply exceeds demand and a "blockage discount" must be accounted for, or finally, (6) if the stock prices increase as a result of the agreement to sell, then the market valuation of the stock may be inadequate. *Bankers Trust, supra,* at 437, 444, 518 F. 2d at 1219–23.

[43] In all instances, there were sufficient sales to indicate the reliability of the market price determinations, yet not so many sales as to indicate the usefulness of determining any "blockage" factors.

While the reorganization and acquisition agreements themselves may have added some value to the U.P. stock, (a main concern of Judge Kashiwa's dissent in *Bankers Trust*) it does not appear to be significant here.

Two factors which give us pause in considering stock market values are the "pessimistic" nature of the market in 1898–99, and the likelihood of reacquisition of the Oregon stock at the time of reorganization. While these factors might possibly cause some doubt as to the reliability of market evaluation, we find that, in the instant case, they do not. The pessimism of investors in the then current economic situation was well-founded. The nation had undergone a severe depression, and recovery was not a foregone conclusion. In addition, the U.P. itself had recently undergone bankruptcy and was in the process of reorganization. Its total mileage had shrunk, and it had no West Coast outlet. The only factors which gave the U.P. any value at all were the possibility of economic recovery and reacquisition of branch lines lost during bankruptcy. We conclude that rather than being of doubtful worth in estimating the value of the U.P. stock, the market serves as its most accurate indicator.[44] In short, the stock exchange values produce the most accurate and comprehensive analysis of the U.P. stock possible after a lapse of some 77 years.

Having determined that we will employ stock market values, we must then decide the dates we will use to appraise the stock. The Excess Profits Tax Regulations mandate valuation at the time of issue.[45] Clearly market quotations are more reliable if they are near in time to the event in question. 10 *J. Merten, Law of Federal Income Taxation*, § 59.16 (1970). In the instant case, the reorganization stock was issued on January 31, 1898. Reorganization preferred first traded on February 2, 1898. Since this date is fairly contemporaneous with the organization, February 2, 1898 becomes the logical date upon which to rate the reorganization preferred. We therefore adopt February 2, 1898. The reorganization common was not traded until February 25, 1898. This is somewhat remote. However, we can derive market values for

[44] Stock exchange quotations automatically take some cognizance of many valuation factors. For example, good will: the nature of the businesses and history of the enterprise; the economic outlook in general and that of the specific industry in particular; estimate of dividend paying capacity; and sales of similar stocks. Most importantly, the stock market provides a "black and white" unbiased and contemporaneous measure of the value of the U.P. stock.

[45] Treas. Reg. 112, § 35.718–1, *supra* note 35, calls for valuation of the U.P. stock "at the time of issuance."

the reorganization common on February 2, 1898 from the price of U.P. Trust Receipts.[46] Thus we again use the February 2, 1898 valuation date to assess the reorganization common.

Determining valuation dates for the acquisition common presents another problem. The U.P. issued this stock in several blocks over a period of ten years.[47] Here we use average market prices during the time period that the U.P. issued each block of shares.

After establishing valuation dates, we must next settle upon a technique to determine the specific market price on the date in question. Although found in the Estate Tax Regulations, a generally accepted procedure in income tax cases is to use the average between high and low prices on the date in question.[48] We accept this method. The average between high and low market values on February 2, 1898 represents the most accurate value for the reorganization stock. The average between high and low for each date during the several time periods in which the U.P. issued its acquisition stock is again the most accurate value for the acquisition stock.

Our first measurement concerns the value of the 750,000 shares of U.P. preferred issued during the reorganization. The *reorganization preferred* was first traded on February 2, 1898. *The average between high and low for the preferred on this date was $62.50.* Thus the court finds that the 750,000 shares of U.P. preferred issued in the reorganization were worth $46.9 million. Note that 122,644 shares of U.P. preferred were traded during the first week of issue, an average of 24,549 per day. Although this is a fairly large block of stock, it is nowhere near the entire amount. Thus there were sufficient shares of U.P. preferred traded at the time of issue to support the validity of the price set by the market, yet not so many shares that the market failed to absorb them.

Evaluation of the *reorganization common* presents another problem. The first shares of U.P. common were not traded until nearly a month after the reorganization, Feb-

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[46] *See* page 77 *infra.*
[47] *See* chart page 77 *infra.*
[48] Treas. Reg. § 20.2031-2(b). *Bankers Trust, supra,* at 437, 518 F. 2d at 1219.

ruary 25, 1898. However, U.P. Trust Receipts, exchangeable for one share of U.P. common and 15/100 of a share of preferred were traded on the market at the time of the reorganization. Using February 2, 1898 Trust Receipt values (an average of $36 per share), less 15/100 of the $62.50 value found for the preferred ($9.375), *we derived a value of $26.625 for the U.P. common on February 2, 1898.* Thus 610,000 shares of new U.P. common were worth $16.2 million. Again we note that approximately 35,321 Trust Receipts per day were traded during the week in question. Again this is sufficient number of shares to find that the market set an accurate trading price.

The U.P. issued the acquisition stock in blocks over a ten-year period. Defendant has presented evidence which permits the court to separate this stock into several blocks and identify an average market price for each block. We adopt this evidence and find the following values for the U.P. acquisition stock.

From	To	Number of Shares	Market Average	Total Value
1-26-99	2-25-99	137, 301	$46. 00	$6, 315, 846
2-26-99	3- 4-99	68, 650	47. 00	3, 226, 660
3- 5-99	3-11-99	27, 460	47. 00	1, 290, 620
3-12-99	6-30-99	31, 642	44. 00	1, 392, 248
7- 1-99	12- 1-99	1, 966	46. 00	90, 436
12- 2-99	6-30-00	3, 688	50. 50	186, 244
7- 1-00	6-30-01	2, 636	91. 50	241, 194
7- 1-01	6-30-02	50	175. 00	8, 750
7- 1-07	6-30-08	100	175. 00	17, 500
		273, 493	----------	$12, 769, 188

Thus the court finds that the investment in the Oregon, the *acquisition common*, was worth $12.8 million.

The reorganization common, the reorganization preferred, and the acquisition common yield total U.P. equity invested capital of $75.9 million. The court believes that this value is neither too pessimistic [49] nor too optimistic.[50] In each case, there are sufficient market sales to bolster the validity

[49] The court believes such valuation is not unduly pessimistic. Notably, the value of the U.P. common and preferred actually fell during 1898 before climbing again.

[50] Defendant's expert would have the court find that the market overvalued the U.P. stock. Since other valuation estimates tend to bolster our finding, we believe that market prices were not unduly optimistic. Certainly by 1899 the market value of the U.P. stock had risen dramatically.

of the price placed upon the shares in the marketplace, yet not so many shares traded that the market found itself unable to absorb them.

In addition, we note that other evidence of value in the record supports our determination. First, although unsupported, the Commissioner's value of $79.4 million is close to that found by the court. Second, by using the net asset values placed in the record by defendant, $116.9–$119.9 million, plus a 15 percent estimate for going concern value and goodwill (factors ignored by defendant in its testimony on net asset values), less debt issued by U.P. during reorganization ($81.7 million in bonds then selling at 92 or $75.2 million in debt securities), we derive a value for the U.P. reorganization assets of $59.2–$62.7 million. Adding the value of the Oregon assets obtained in the acquisition, $12.8 million, we derive a reasonable estimate of total equity based upon net assets and goodwill less debt of $72.0 million to $75.5 million. The stock market values found by the court are nearer the $75.5 million figure. Our stock market figures for the reorganization stock appear to be well-founded.

Finally, viewing the acquisition stock alone, various facts in the record again bolster our determination of value. For example, by using an 1899 average of the price-earnings (P/E) ratios of three comparable railroads[51] (9.8), we find that of the $5.12 per share U.P. earnings in 1899, some $1.4 million in earnings were attributable to the acquisition common. (273,493 shares x $5.12 per share.) Multiplying the P/E ratio for the similar stocks by the earnings attributable to the U.P. acquisition common, we find a reasonable estimate for the Oregon of $13.7 million.[52] Certainly the stock market values ($12.8 million) for the acquisition common are conservative estimates of their value.

Thus the value determined by the Commissioner, the value based upon net assets, and price-earnings ratios lend support to our valuation.

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[51] The Southern Pacific [SP], the Northern Pacific [NP] and the Chicago and Northwestern [CNW], three railroads which defendant's expert excluded from his category of "established dividend payers" and, therefore, similar to the U.P. The 1899 P/E ratio for the SP was 8.5, the NP, 8.4 and the CNW, 12.6. Thus the average P/E ratio for these three railroads in 1899 was 9.8.

[52] *See American Steel Foundries, supra,* 153 Ct. Cl. at 252 for use of this valuation technique.

In short, using stock market prices to value the equity invested capital of the U.P. for 1942 excess profits tax purposes, the court finds that the Commissioner overvalued the U.P. stock by some $3.5 million. Accordingly, defendant is entitled to a tax offset for the excess equity invested capital credit granted to plaintiff in 1942 based upon this figure.

Plaintiff's other contention is that it is entitled to include cash contributions received in its equity invested capital *in addition* to the value of the stock issued. The court rejects this assertion. Since new U.P. stock was issued in exchange for old U.P. common, the Oregon common, *and cash*, a proper measurement of the equity can be achieved by viewing either side of the equation; the value of the U.P. stock issued *or* the value of the stock and cash received. To allow plaintiff to include both the stock issued *and* the cash received in its equity invested capital is to "add both sides of the bargain." Certainly the cash received by the U.P. was a partial payment for the stock issued. We, therefore, hold that plaintiff cannot include the cash payments received since we value its equity with reference to the value of the stock issued.

In summary, the court finds that there is sufficient probative evidence to establish reasonable per share values for the U.P. stock issued in the reorganization and acquisition. We find that defendant has overcome the Commissioner's presumption of correctness. The court further finds that defendant has met its burden of establishing that the Commissioner overvalued the U.P. stock. We value the stock as near its issue date as possible. The reorganization preferred was worth $62.50 per share, the reorganization common $26.625 per share, and the acquisition common ranged from $44 per share to $175 per share depending upon the date of issue. The total value of the stock issued, plaintiff's equity invested capital for 1942 excess profits tax credit purposes, was $75.9 million.[53]

To recapitulate, we find that plaintiff is entitled to recover on its refund claim based upon its right to "expense" minimum rule property in its 1942 return (Part I). Plaintiff may also recover on its contention that it would include stock of

[53] We hold for defendant on additional defense 1. Plaintiff cannot prevail on its counts 5, 6 and 9.

certain leased line subsidiaries in its capital assets (Part V). Finally, with regard to "donations and grants" given to plaintiff to spur its construction, we conclude that some of these grants were includable capital assets and some were not. Therefore, we hold in part for plaintiff on this assertion (Part X).

We further determine that plaintiff is not entitled to recover refunds for other allegations since it cannot deduct 1943 payroll taxes in 1942 (Part II); it cannot include certain stock subscription rights in its earnings and profits (Part IV); and cannot receive interest on a 1948 agreement with the Commissioner of Internal Revenue (Part VI). Plaintiff also may not recover an offset to setoffs claimed by defendant because it cannot include proceeds from certain land sales in its earnings and profits (Part VII).

Defendant is entitled to prevail on its "additional defense" that plaintiff erroneously included unamortized bond discount and expense in its total assets (Part VIII). Further, we find for defendant on another "additional defense" that plaintiff mistakenly failed to treat other bond discounts and expenses as "interest" (Part IX). We also hold that defendant is entitled to recover an offset based upon its claim that the Commissioner overvalued plaintiff's equity invested capital (Part XI).

Finally, the court severs and remands for further consideration by the trial judge the question of whether plaintiff is entitled to increase its earnings and profits by $13 million due to certain accounting errors alleged to have occurred in 1900–1907 (Part III).

Accordingly, we find for plaintiff in Parts I, V and in some sections of Part X. We deny plaintiffs claims in Parts II, IV, VI and VII. We further hold for defendant in Parts VIII, IX and XI. The amount of the recoveries will be determined pursuant to Rule 131(c). Finally, we remand Part III for further proceedings consistent with this opinion.

NICHOLS, *Judge*, concurring in part and dissenting in part:

I concur and join in the court's opinion except for Part V, headed *Leased Line Subsidiaries*. As to this, I dissent with all respect.

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Opinion of Judge Nichols Concurring and Dissenting in Part

The court here adopts without change the opinion recommended by Trial Judge Schwartz. While the latter, with his usual keenness of analysis, recognizes fully the difficulties of his position, he ends up applying this court's "source of supply" line of decisions which extend the *Corn Products* v. *Commissioner*, 350 U.S. 46 (1955) doctrine to cases in which a corporation invests in stock of another corporation to obtain a source of supply. *Waterman, Largen & Co.* v. *United States*, 189 Ct. Cl. 364, 419 F. 2d 845 (1969), *cert. denied*, 400 U.S. 869 (1970), and cases there cited. However, in a strangely forgotten decision, *Dearborn Co.* v. *United States*, 195 Ct. Cl. 219, 444 F. 2d 1145 (1971), a unanimous court laid down certain lines beyond which *Corn Products* and *Waterman, Largen* would not be applied, and instead the normal rule would obtain, that the purchase of corporate stock, except by a dealer in securities, is a capital transaction.

Admitting that case was close, former Trial Judge Davis distinguished it because he found the purchasing corporation was motivated by substantial investment purpose and intent, besides the business purpose of assuring a source of supply. The main factors supporting this conclusion were (a) the purchaser did not pay a premium over the market value of the stock, or in other words, the purchase, if an investment, was not an unattractive one at the price paid, (b) the acquisition was meant to be permanent, not to be unloaded at the end of some temporary emergency, and (c) the purchaser intended to benefit by receipt of dividends and by exacting a management fee to run the business, not just to integrate the subsidiary's operations into its own and make it a mere feeder of materials.

I do not find that Trial Judge Schwartz applied the same tests. As I read him, the decisive factor here is that the Union Pacific and the leased lines, run as a unified operation, could have been and no doubt were more profitable than the same lines controlled and operated separately. Without them, the Union Pacific as previously known was truncated and incomplete. To be sure! But if this is all, what we are coming to is a rule that it is not a capital investment whenever one corporation purchases control of another with the purpose, alone or among others, of integrating their operations. The

kind of inquiry Trial Judge Davis made will be foreclosed because it will be irrelevant whether the purchase is attractive, viewed as an investment, whether it was intended to be permanent, constituting a permanent addition to the purchaser's fixed assets, and whether the purchaser will or will not derive the benefits a prudent investor in an unrelated enterprise would seek.

It is obvious here that the acquisition of the Oregon Short Line and the others were intended to be permanent, and have been so up to now. The Oregon Short Line and the others were themselves investors in railroad securities, and as to their investments it would appear the Union Pacific got an investment benefit. As to the other criteria, I do not find answers in the findings. I do not think the plaintiff has sustained its burden of proof.

In penning the above few words, I have assumed, as I must, the entire soundness of *Waterman*, *Largen* and our other decisions as well as, of course, *Dearborn*, despite previous qualms. This court's application of *Corn Products* in its "source of supply" cases can roll on down the track without any challenge by me, unless derailment by the Supreme Court or by Congress occurs. This is an area of law where *stare decisis* must prevail in this court. It is beyond our proper power now to make it easy or simple to determine whether a transaction is a capital one for tax purposes, or to do it on the basis of objective facts and statutory language, without inquiry or speculation into the undisclosed state of mind of corporate officers, possibly ones, as here, long since deceased, and I do not so urge. My argument is directed simply against extending *Waterman*, *Largen* uncritically to new situations not covered by it as a precedent, and to failure to apply standards as we applied them in *Dearborn*.

I agree with the decision in *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298 (1972) does not overrule *Waterman*, *Largen*. It holds that a borrower from a Bank for Cooperatives, obliged to purchase a stated quantity of bank stock in lieu of a higher rate of interest, nevertheless makes a capital investment in the stock. The situation is far removed from that in our "source of supply" cases. The *Corn Products* doctrine is not mentioned. It may perhaps afford a slight

clue that the Supreme Court is not so enamored of expanding *Corn Products* as we are.

FINDINGS OF FACT

JURISDICTIONAL AND GENERAL

1. Plaintiff was at all times pertinent hereto a corporation organized and existing under the laws of the State of Utah, with its office and principal place of business at 120 Broadway, New York, New York 10005.

2. Jurisdiction to hear and determine this cause is conferred upon the court by section 7422(a) of the Internal Revenue Code of 1954. Jurisdiction of the subject matter is conferred upon the court by section 1491, Title 28, United States Code.

3. Plaintiff seeks a judgment for (1) $13,409,961.46 (consisting of $9,222,801.78 in statutory interest for 1942 and $4,187,159.68 in income and excess profits tax) and assessed interest thereon paid for 1942 or such other amount as may be legally refundable for 1942, together with statutory interest thereon.

4. For federal tax purposes, plaintiff kept its books and reported its income on the accrual and calendar year basis.

5. On or about March 15, 1943, plaintiff filed a timely tentative corporation income and declared value excess profits tax return (Form 1120) and a timely tentative corporation excess profits tax return (Form 1121). On or about June 15, 1943, pursuant to a granted extension, plaintiff timely filed its final corporation income and declared value excess profits tax return (Form 1120) and final corporation excess profits tax return for the calendar year 1942 (Form 1121). Payments of the tax shown to be due thereon and two additional payments were made on or about the following dates:

Date of payment	Type of tax	Amount paid	
		Amount of tax	Amount of interest
Mar. 15, 1943	Income and declared value excess profits	$10,018,216.50	
June 15, 1943	do	9,221,074.86	
Sept. 15, 1943	do	9,619,645.68	
Dec. 15, 1943	do	9,619,645.68	
Dec. 1, 1944	Excess profits	3,525,000.00	$361,745.90
July 16, 1946	Income	10,696.86	2,141.13

6. On or about October 4, 1946, plaintiff timely filed a claim for refund of income and excess profits taxes in the amount of $1,807,514.54, or such larger amount as might be legally refundable, together with statutory interest thereon for the tax year 1942. On or about April 25, 1949, plaintiff timely filed a claim for refund of income and excess profits taxes in the amount of $7,394,419.35 plus assessed interest in the amount of $361,745.90, a total of $7,756,165.25 or such larger amount as might be legally refundable, together with statutory interest thereon for the tax year 1942. On or about April 10, 1951, plaintiff timely filed a claim for refund of income and excess profits taxes in the amount of $390,828.41 or such larger amount as might be legally refundable, together with statutory interest thereon for the tax year 1942. On or about September 11, 1953, plaintiff timely filed a claim for refund of income and excess profits taxes in the amount of $348,705.41, or such larger amount as might be legally refundable, together with statutory interest thereon for the tax year 1942.

7. On July 16, 1946, $12,837.99 in declared value excess profits tax for 1942 was credited against plaintiff's income tax liability for 1942; $196.82 in declared value excess profits tax for 1942 was credited against the tax liability of the St. Joseph & Grand Island Railway Company for 1942; $45,685.38 in declared value excess profits tax for 1942 was refunded to plaintiff with interest of $9,178.87; and $694,754.62 in excess profits tax for 1942 was refunded to plaintiff with interest of $68,742.63.

8. On September 16, 1960, after the audit of plaintiff's tax returns for 1942 was finally completed, a total of $7,793,219.55 was refunded or paid to plaintiff, consisting of $3,729,059.29 in income tax for 1942, $2,141.13 in assessed interest thereon, $13,462.80 in declared value excess profits tax for 1942, and $4,048,556.33 in statutory interest. On September 16, 1960, there was assessed against plaintiff a deficiency in excess profits tax for 1942 of $4,654,621.45 plus interest of $300,639.16, which was satisfied by a credit of $4,206,773.93 in income tax for 1942 and a post-war credit of $748,486.68.

9. Pursuant to Form 872, "Consent Fixing Period of

Limitation Upon Assessment of Income and Profits Tax," timely executed on behalf of the plaintiff and the Commissioner of Internal Revenue, the period for assessment of income and excess profits taxes for the tax year 1942 did not expire prior to June 30, 1961.

10. On December 28, 1961, plaintiff filed a timely claim for refund for 1942 in the amount of $13,409,961.46 or such further amount as may be refundable, together with statutory interest thereon. Of the $13,409,961.46 claimed, $9,222,-801.78 was for statutory interest on amounts previously refunded or credited and the balance of $4,187,159.68 was for income and excess profits tax.

11. Statutory notices of disallowance were mailed to plaintiff on September 26, 1960, with respect to the claims filed on April 26, 1949, and April 10, 1951, and on August 13, 1962, with respect to the claim filed on December 28, 1961. No such notice has been issued with respect to the claim filed on October 4, 1946. Since less than 2 years elapsed between the mailing of the notices of disallowance and the filing of this suit, this action is timely brought.

12. No action or suit has been commenced or is pending in any other court on account of these claims, and plaintiff is the owner of the claims herein stated.

13. After consideration of all refunds and credits, plaintiff has paid for 1942 $30,481,263.37 in income tax and $7,484,-866.83 in excess profits tax. Plaintiff seeks to recover some portion of these payments as well as statutory interest.

I. "MINIMUM RULE" ACQUISITIONS

14. During the taxable year, plaintiff acquired miscellaneous units and items of road property and equipment which had an individual unit or item cost of $100 or more but less than $500. The aggregate cost incurred by plaintiff for these units and items during the taxable year was $113,-717.84. Each of these units and items was a capital asset, and the amounts totaling $113,717.84 constituted expenditures which would have been capitalized, except for the minimum rule which is the subject of the next following finding.

15. The Uniform System of Accounts prescribed by the ICC provided, for 1942, in part as follows:

> (a) When the property change involves: (1) The acquisition of property (other than land, a section of track, or a unit of equipment) the cost of which is less than $500.00; (2) the betterment of property (see paragraph 10 of Section 2 of the General Instructions in the Classification of Investment of Road and Equipment), the excess cost of which is less than $500.00; (3) the retirement of property (other than land, a section of track, or a unit of equipment), the ledger value of which is less than $500.00, the cost of the property acquired or the value of the salvage from the property retired shall be appropriately included in operating expenses, and no adjustment shall be made in the property investment account.
>
> (b) The carrier shall not parcel expenditures or retirements under a general plan for the purpose of bringing the accounting therefor within this rule, neither shall it combine unrelated items of property for the purpose of excluding the accounting therefor from the rule.
>
> (c) This exception to the general instructions of this classification shall not apply to: (1) property changes involving the retirement and replacement of property when either the ledger value of the property retired or the cost of the property acquired is $500.00 or more. (See Section 7 of these instructions.) (2) property changes involving the retirement of property the cost of which is included in the investment account and which is not replaced. (See Section 8 of these instructions.)
>
> (d) The carrier is permitted to adopt for the purpose of its accounting a limit of less than the aforesaid amounts provided it first files with the Commission the maximum amount which it proposes to adopt and makes no subsequent change in this amount except by authority of the Commission, except that when the carrier adopts a limit of less than $500.00 in reporting property changes to the Bureau of Valuation for valuation purposes it shall adopt a like minimum for accounting purposes in order to coordinate the original cost with the physical property included in the inventory.

The foregoing rule is hereinafter referred to as the "ICC minimum rule" or "minimum rule". The same rule was in effect for 1940 and 1941; a similar rule was in effect for 1921 through 1939 with a $100 minimum; no such rule was in effect

for 1915 through 1920; a similar rule was in effect for 1914 with a $200 minimum.

16. On its federal income tax returns for each of the taxable years 1921 through 1939, plaintiff included in various items of operating expense the amounts expended by it in acquiring units and items of road property which qualified as minimum rule acquisitions under the applicable Uniform System of Accounts prescribed by the Interstate Commerce Commission for each such taxable year. On the audits of these returns, the Commissioner of Internal Revenue did not disallow as a deduction any of the minimum rule acquisitions.

17. On its federal income tax returns for 1940 and 1941, plaintiff deducted amounts up to $500 with respect to the minimum rule then in effect. On the audits of these returns, the Commissioner of Internal Revenue did not disallow as a deduction any minimum rule acquisitions.

18. On its federal income tax return for 1942, plaintiff included in various items of operating expense the $113,717.84 referred to in finding 14.

19. On audit of plaintiff's income tax return for 1942, the Commissioner of Internal Revenue disallowed the deductions totaling $113,717.84 claimed for minimum rule acquisitions, and allowed plaintiff a deduction of $3,790.59 as amortization of the $113,717.84 in minimum rule acquisitions.

20. The average useful life of the units and items of minimum rule acquisitions was 15 years.

21. For the taxable year 1942, plaintiff utilized the retirement-replacement method of accounting for depreciation of its road property. Beginning with the taxable year 1943, the plaintiff changed its method of accounting for the treatment of road property by using the ratable depreciation method. The change in the method of accounting for the road property from the retirement method to the ratable method made no change in the accounting for items acquired under the $500 minimum rule. These items, which had been charged off as operating expenses before 1942, as set out in findings 16 and 17, continued to be so charged off.

22. Schedule 1 of the Appendix hereto presents:

(a) The amounts (under Column 1 of Schedule 1) actually deducted by plaintiff on its corporate income tax returns

as operating expenses in each of the taxable years 1942 through 1947 and 1949 through 1967 for minimum rule acquisitions which had an individual unit or item cost of at least $100 or more but less than $500.

(b) The amortization of the amounts described in subparagraph (a) of this finding for the taxable years 1942 through 1960 (and which are set forth under Column 1 of Schedule 1) over a 15-year period which reflects the treatment accorded these amounts by the defendant's agents.

(c) The amortization of the amounts described in subparagraph (a) of this finding for the taxable years 1961 through 1964 (and set forth under Column 1 of Schedule 1) over a 15-year period which is based upon the plantiff's understanding as to the adjustments which will be included in the reports which are being prepared by defendant's agents for the taxable years 1961 through 1964. These proposed adjustments are consistent with the treatment proposed by defendant's agents for the taxable years 1942 through 1960.

(d) The amortization of the amounts described in subparagraph (a) of this finding for the taxable years 1965 through 1967 (and which are set forth in Schedule 1) over a 15-year period which is based upon a projection of the adjustments which plaintiff believes will be made by defendant's agents for said taxable years. Said projection is based upon and is consistent with the adjustments made or proposed by the defendant's agents for the taxable years 1942 through 1964.

(e) The total amount of amortization deduction allowed by the defendant's agents for the years 1942 through 1960.

(f) The total amount of amortization deduction to be allowed by the defendant for the taxable years 1961 through 1964 which is based upon plaintiff's understanding as to the adjustments which will be made for such taxable years and which is consistent with the adjustments actually made by defendant's agents for the taxable years 1942 through 1960.

(g) The total amortization deduction to be allowed for the taxable years 1965 through 1967, which has been projected by the plaintiff based upon the actual adjustments made by the defendant's agents for the taxable years 1950 through 1960 coupled with plaintiff's understanding as to the adjustments

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which will be made by the defendant's agents for the taxable years 1961 through 1964.

(h) The 15-year amortization spread on Schedule 1 actually is spread over a 16-calendar-year period. The amounts amortized in the first and sixteenth year reflect, in each instance, one-half of the annual amortization. This is consistent with what is commonly known as the "half-year averaging-convention" whereby those items which are acquired during the year are considered to have been acquired on and on hand from the first day of July of such year.

23. Schedule 2 of the appendix hereto presents a reasonable reconstruction of the amounts which were included in operating expenses under the minimum rule in effect for the years 1927 through 1941. Such amounts were mathematically derived by applying a percentage test to actual operating expenses for the years involved. The percentage used was derived from an analysis of the actual experience of the company for the years 1942 through 1949. The percentage test was derived and applied specifically as follows:

(a) Each work order for the years 1942 through 1949 disclosing an expenditure of less than $500 was analyzed. Statements were prepared listing work orders, descriptions and amounts charged to operating expenses, which, except for the minimum rule, would have been charged either to the depreciable or nondepreciable investment accounts.

(b) The total amounts of such operating expenses when analyzed were as follows:

Year	Depreciable property	Non-depreciable property
1942	$115,524	$13,072
1943	144,044	15,885
1944	183,300	17,315
1945	191,852	18,634
1946	154,933	11,829
1947	126,141	7,606
1948	116,313	11,701
1949	129,685	8,254
Total	1,161,792	104,296

(c) The grand total of the items charged to operating expenses ($1,161,792) which, except for the minimum rule, would have been charged to the depreciable investment account was used as a numerator of a fraction which had as its

denominator an amount of $95,715,171, which was the total amount of the operating expenses in the following accounts:

Account No.:	Description
208	Bridges, trestles and culverts.
221	Fences, snow sheds and signs.
227	Station and office buildings.
229	Roadway buildings.
231	Water stations.
233	Fuel stations.
235	Ships and engine.
247	Telegraph & Telephone lines.
249	Signals and interlockers.
253	Power transmission systems.
265	Misc. structure.
269	Roadway machines.
273	Public improvements, maintenance.
281	Right-of-way expenses.

(d) For the non-depreciable property expenses the grand total of the minimum rule items ($104,296) was used as a numerator for a fraction which had as its denominator the amount of $244,972,595, which was the total amount of the operating expenses in the following accounts:

Account No.:	Description
202	Roadway maintenance.
214	Rails.
216	Other track material.
218	Ballast.
220	Track laying and servicing.

(e) The following operating expense accounts were not normally charged with expenditures under the minimum rule and were therefore omitted from the denominator:

Account No.:	Description
201	Superintendence.
206	Tunnels and subways.
210	Elevated structures.
212	Ties.
237	Grain elevators.
239	Storage warehouses.
241	Wharves and docks.
243	Coal and ore wharves.
267	Paving.
268	Description not available.

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Account No.:	Description
270	Description not available.
270½	Road-Amortization of defense projects.
271	Small tools and supplies.
272	Removing snow, ice and sand.
274	Injuries to persons.
275	Insurance.
276	Stationery and printing.
277	Other expense.
279	Maintenance of joint tracks, yards and other facilities.
280	Equalization—way and structures.

(f) The fraction for depreciable property described in subparagraph (c), above, resulted in a percentage of 1.2138% which was then applied to the total amounts ($5,963,685) of the operating accounts enumerated in subparagraph (c), above. The application of this percentage to the total of each of the operating expense accounts resulted in an aggregate amount of $71,173 for the year 1927 for depreciable property which, except for the minimum rule, would have been charged to the investment account.

(g) The fraction for non-depreciable property described in subparagraph (d), above, resulted in a percentage of .0426% which was then applied to the total amounts ($14,368,201) of the operating accounts enumerated in subparagraph (d), above. The application of this percentage to the total of each of the operating expense accounts resulted in an aggregate amount of $6,121 for the year 1927 for non-depreciable property which, except for the minimum rule, would have been charged to the investment account.

(h) The $71,173 referred to in subparagraph (f), above, and the $6,121 referred to in subparagraph (g), above, were totaled to give $77,294 as the total $500 minimum rule items. Since in 1927 a $100 minimum rule was in effect, 20% of the $77,294 represented the minimum rule items deducted in that year.

(i) The same procedure, as described in subparagraphs (a) through (h), above, was followed in determining the amounts expended under a minimum rule for the years 1927 through 1941. Since the minimum rule for the years 1927 through 1939 was $100, 20% of the amounts determined constituted a reasonable basis for determining the amounts ex-

pended for minimum rule items, which except for such rule, would have been charged to the investment account. The amounts so determined are set forth in the column captioned "Amount" on Schedule 2 for each of the years 1927 through 1945. The columns under the yearly dates 1927 through 1967 indicate the amortization of the "Amounts" over a 15-year period with the application of the half-year averaging convention (previously explained in subparagraph (h) of finding 22).

24. Plaintiff's minimum rule items for the taxable year 1942 may be tabulated as follows:

	Number of items	Percent	Aggregate dollars	Percent
$0.01 to $99.99	473	46.28	$21,966.72	14.62
100.00 to 199.99	279	27.30	39,795.20	26.49
200.00 to 299.99	116	11.35	29,110.16	19.38
300.00 to 399.99	95	9.30	33,099.99	22.03
400.00 to 499.99	59	5.77	26,270.35	17.48
Total	1,022	100.00	----------	100.00

The significance of the figures lies in the modest number of items in the higher dollar ranges and in the rough equality in number between items under and items over $100. The changes worked by the 1939 raising of the $100 to $499.99 seem not unreasonable; certainly no flood of items costing close to $500 were brought within the rule.

(The foregoing tabulation differs slightly from that in plaintiff's proposed finding, to which defendant did not object. The proposed finding shows 1,026 items to a total of $146,565.93, with percentages and dollar subdivision figures slightly different than in this finding. Both this finding and the proposed finding are based on defendant's exhibit 11. The differences are not material; both sets of figures equally support the significance ascribed to them in this finding.)

25. The plaintiff owned road property and equipment and miscellaneous road property having on its books an average net value (after depreciation) of $442,726,751.78 during the taxable year 1942.

26. The minimum rule acquisitions of $113,717.84 in question in this proceeding amounted to .00026 of the amount referred to in the preceding finding.

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Findings of Fact

27. The true relationship of minimum rule acquisitions to road property and equipment (the account into which the acquisitions would go if they were not expensed) is even smaller than .00026, because the $113,717.84 is the figure for plaintiff and its leased lines, and the $442 million figure is for plaintiff alone.

28. The plaintiff and its subsidiary companies during the years 1927 through 1942 had the following railway operating expenses and expended at least the following for minimum rule acquisitions. In addition, the proportion of minimum rule acquisitions to total operating railway expenses for the years 1927 through 1942 equal the percentages shown in the last column below:

Year	Total minimum rule acquisitions	Railway operating expenses	Ratio
1927	$15,459	$141,938,527	.00011
1928	16,846	149,060,334	.00011
1929	18,319	149,682,240	.00012
1930	14,625	133,538,866	.00011
1931	10,709	112,157,457	.00010
1932	5,782	80,513,455	.00007
1933	6,082	76,139,778	.00008
1934	7,322	85,353,628	.00009
1935	8,899	95,208,407	.00009
1936	9,602	108,725,114	.00009
1937	10,127	116,834,578	.00009
1938	8,311	105,731,151	.00008
1939	9,732	117,858,588	.00008
1940	50,343	120,949,111	.00042
1941	77,485	159,907,895	.00048
1942	146,566	218,307,770	.00067

29. The minimum rule method employed by plaintiff for acquisitions within the scope of the rule constituted a method of accounting, and financial statements and figures for tax purposes based upon the method clearly reflect plaintiff's income for tax purposes in the year in question.

II. PAYROLL TAXES

30. During 1942, plaintiff paid to its employees $1,103,413.31 in vacation pay earned in 1941. On payroll tax returns filed for the calendar year 1942, plaintiff reported the $1,103,413.31 in vacation pay paid in 1942 and a payroll tax with respect thereto of $64,108.31, which it paid in 1942.

31. During 1943, plaintiff paid to its employees $1,518,624.02 in vacation pay earned in 1942. On payroll tax returns

filed for the calendar year 1943, plaintiff reported the $1,518,624.02 in vacation pay paid in 1943, and a payroll tax with respect thereto of $90,358.13, which it paid in 1943.

32. The vacation pay earned by plaintiff's employees in 1942 was not payable or paid until 1943.

33. The vacation pay earned by an employee in 1942 could be forfeited if his employment were terminated in 1943, for reasons other than retirement, prior to the time his vacation began.

34. The record shows only the amount of vacation pay paid in 1943 which is stated in finding 31. It does not show the amount of vacation pay earned by plaintiff's employees in 1942 or the amount thereof forfeited in 1943.

35. In the event plaintiff could not release an employee for a vacation in 1943, plaintiff was obligated to pay him an allowance in lieu of the vacation.

36. Aside from whether at the end of 1942 it was possible to determine the amount of vacation pay earned by plaintiff's employees, it was not possible at that time to determine the payroll taxes thereon because some unpredictable portion of the vacation pay could be tax-exempt as having been paid in a month when the employee had already received $300 in other compensation, the payroll taxes in question being imposed on only the first $300 of compensation for each calendar month, under section 1520 of the Internal Revenue Code of 1939 and Section 8(a) of the Railroad Unemployment Insurance Act.

37. Of the vacation pay disbursed in 1942 and 1943, it appears that some portion was tax exempt as having been paid in a month when the employee had already received $300 in compensation. The aggregate tax rate was 6 percent for 1942 and 6.25 percent for 1943, under section 1520 of the Internal Revenue Code of 1939 and Section 8(a) of the Railroad Unemployment Insurance Act. Plaintiff paid in 1942 vacation pay of $1,103,413. Six percent of this amount is $66,205, but plaintiff paid only $64,108 in payroll tax. Plaintiff paid in 1943 vacation pay of $1,518,624. Six point twenty-five percent of this amount is $94,914, but plaintiff paid only $90,358 in payroll tax. In the absence of any other explanation by plaintiff, the differences can only be attributed to

tax-exempt payments; that is, payments made in a month when the employee had already received $300.

38. On its federal income tax return for 1942, plaintiff deducted $1,103,413.31 for vacation pay paid in 1942 and $64,108.31 in payroll tax with respect thereto. On its federal income tax return for 1943, plaintiff deducted $1,518,624.02 for vacation pay paid in 1943 and $90,358.13 in payroll taxes with respect thereto.

39. On audit of its 1942 federal income tax return, plaintiff claimed, and was allowed, a deduction for the year 1942 of the entire amount of the vacation pay which accrued during 1942 but was not payable to its employees until 1943. The Commissioner of Internal Revenue (relying on I.T. 3956, 1949–1 Cum. Bull. 78) allowed plaintiff an additional deduction for vacation pay of $415,210.71, representing the difference between the vacation pay paid in 1943 and the vacation pay deduction claimed on the return for 1942, but he did not allow plaintiff any additional deduction for payroll tax with respect to vacation pay.

40. In its claim for refund for 1942, plaintiff claimed a deduction in the amount of $26,249.82 for federal income tax purposes, representing the difference between the payroll tax paid in 1943 and the payroll tax paid in 1942 as described above in findings 30 and 31.

41. The Commissioner of Internal Revenue did not allow the deduction referred to in the preceding finding.

42. As of December 31, 1942, it was not possible to compute the amount of payroll taxes plaintiff would have to pay in 1943 with respect to vacation pay earned in 1942. First, the amount of vacation pay to be disbursed in 1943 was uncertain because it was forfeitable, as stated in finding 33. Second, some unpredictable amount of vacation pay could be tax exempt, as stated in finding 36.

IV. STOCK SUBSCRIPTION RIGHTS

43. During the taxable years ended December 31, 1922, 1923, and 1925, plaintiff and its wholly owned subsidiary, the Oregon Short Line, as the holders of common stock of the Illinois Central Railroad Company, received by distribution

from the Illinois Central rights to subscribe to its convertible preferred stock as follows:

Distributee	Date of distribution	Number of rights
Union Pacific Railroad Company	May 16, 1922	138,000
Do	Oct. 23, 1923	138,000
Do	Oct. 22, 1925	138,000
Oregon Short Line Railroad Company	May 16, 1922	87,000
Do	Oct. 23, 1923	87,000
Do	Oct. 22, 1925	95,700

44. For each share of Illinois Central common stock held, one right was received by the aforesaid distributees. Ten rights together with the subscription price of $100 entitled the said distributees, upon exercise, to one share of Illinois Central convertible preferred stock.

45. The high and low quotations on the New York Stock Exchange of the convertible preferred stock and the stock rights, on the dates indicated, were as follows:

Illinois Central Convertible Preferred Stock

Date	High	Low
May 15, 1922	107¼	107
May 16, 1922	—no quotations—	
Oct. 23, 1923	108	108
Oct. 22, 1925	118	116

Illinois Central Convertible Preferred Stock Rights

Date	High	Low
May 15, 1922	67 cents	67 cents
Oct. 23, 1923	7/16	5/16
Oct. 19, 1925	1¼	1 7/16
Oct. 22, 1925	1 11/16	1 9/16

46. The stock rights were exercised by plaintiff and the Oregon Short Line on June 26, 1922, December 1, 1923, and December 10, 1925.

47. On February 9, 1914, the Oregon Short Line owned 87,000 shares of Illinois Central common, with a cost of $10,005,000.

48. On November 22, 1924, the Oregon Short Line acquired an additional 8,700 shares of Illinois Central common by payment of $87,000 and the exercise of certain rights to acquire such shares of common stock.

49. As indicated in finding 43 above, the Oregon Short Line received from the Illinois Central $269,700 rights to sub-

scribe to its convertible preferred stock. By exercising these rights and payment of $2,697,000 in cash, the Oregon Short Line acquired 26,970 shares of the convertible preferred stock.

50. For the 26,970 shares of preferred, the Commissioner of Internal Revenue determined that the basis to the Oregon Short Line was $2,950,102.23, consisting of the subscription price of $2,697,000 plus $253,102.23 allocated from the basis for the 95,700 shares of common in accordance with Section 214(e) of the Revenue Act of 1939 and the Treasury Regulations issued thereunder. As a result of the allocation, the Commissioner determined that the basis for the 95,700 shares of common was $10,621,897.77 or $110.99 per share.

51. On April 30, 1930, the Oregon Short Line sold to plaintiff 87,000 shares of Illinois Central common in satisfaction of a debt owing to plaintiff in the amount of $10,005,000. No adjustment to earnings and profits of Oregon Short Line or plaintiff was made on account of this transaction. The Commissioner of Internal Revenue on audit determined that the basis for this stock to the Oregon Short Line was $9,656,270.70.

52. The high and low quotations on the New York Stock Exchange for the aforesaid convertible preferred stock, on the dates indicated, were as follows:

Illinois Central Convertible Preferred Stock

Date	High	Low
June 26, 1922	108¼	107⅝
Nov. 30, 1923	104⅞	108¾
Dec. 1, 1923	(Saturday, no quotation)	
Dec. 10, 1925	118¼	117

53. On December 30, 1935, the Oregon Short Line distributed to plaintiff as a dividend in kind the entire 26,970 Illinois Central preferred stock acquired by it upon the exercise of the aforesaid rights.

On account of this dividend distribution, plaintiff increased its earnings and profits and the Oregon Short Line decreased its earnings and profits by the amount of $2,697,000.

54. On December 30, 1935, the Oregon Short Line also distributed to plaintiff its remaining 8,700 shares of Illinois Central common stock. On account of this transaction, plaintiff

increased its earnings and profits and decreased those of the Oregon Short Line by the amount of $870,000. The Commissioner of Internal Revenue on audit determined that the basis for this stock to the Oregon Short Line was $965,627.07.

55. On account of the transfer to plaintiff by the Oregon Short Line of (a) the 26,970 shares of Illinois Central convertible preferred on December 30, 1935, and (b) the 8,700 shares of Illinois Central common on December 30, 1935, the plaintiff and the Commissioner of Internal Revenue increased plaintiff's earnings and profits by $3,567,000 and decreased those of the Oregon Short Line by the same amount. This sum of $3,567,000 is equal to the Oregon Short Line's payment of $870,000 for 8,700 shares of common on October 22, 1924 and its payments of $2,697,000 for 26,970 shares of convertible preferred.

56. For the years 1922, 1923 and 1925, plaintiff and its railroad subsidiaries, including the Oregon Short Line, filed consolidated income tax returns.

57. On the consolidated returns referred to in finding 56, no amount was included as a dividend in gross income on account of the receipt of the rights referred to in finding 43.

58. For the taxable years 1930 and 1935, plaintiff and its railroad subsidiaries, including Oregon Short Line. filed consolidated federal income tax returns. Under the federal income tax laws applicable to 1930 and 1935, the distribution of the securities described in finding 53 and findings 51 and 54 constituted intercompany transactions and were eliminated in computing plaintiff's consolidated federal income tax liability for 1930 and 1935.

59. In computing plaintiff's accumulated earnings and profits, the Commissioner of Internal Revenue refused to include any amount for the distribution and exercise of the stock subscription rights described in finding 43.

60. As of December 31, 1922, the Illinois Central Railroad Company had accumulated earnings and profits of no less than $8,897,224.38.

61. As of December 31, 1923, the Illinois Central Railroad Company had accumulated earnings and profits of no less than $8,761,784.00.

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62. As of December 31, 1925, the Illinois Central Railroad Company had accumulated earnings and profits of no less than $22,173,584.00.

63. The spreads between the market value of the Illinois Central convertible preferred stock and the subscription price on the date of distribution of the rights entitling the recipient to exercise said subscriptions were as follows:

Distribution date	Market value of convertible preferred stock as of date of distribution	−	Subscription price	=	Spread
May 16, 1922	107.25		100.00		7.25
Oct. 23, 1923	108.00		100.00		8.00
Oct. 22, 1925	117.00		100.00		17.00

64. The spreads between the fair market value of the Illinois Central convertible preferred stock and the subscription price on the date that the rights entitling the recipient to subscribe were actually exercised were as follows:

Exercise date	Market value of convertible preferred stock as of exercise date	−	Subscription price	=	Spread
June 26, 1922	108.125		100.00		8.125
Dec. 1, 1923	104.875		100.00		4.875
Dec. 10, 1925	117.25		100.00		17.25

65. The number of shares of Illinois Central convertible preferred stock acquired by exercise of stock rights which were distributed to the plaintiff and the Oregon Short Line times the respective spreads as of the date of distribution and the date of exercise of said stock rights were as follows:

Distribution date	Number of shares	×	Distribution spread	=	Aggregate value of distribution—date spread
May 16, 1922	22,500		7.25		$163,120
October 23, 1923	22,500		8.00		180,005
October 22, 1925	23,370		17.00		397,290

Exercise date	Number of shares	×	Exercise spread	=	Aggregate value of exercise—date spread
June 26, 1922	22,500		8.125		$182,812.50
December 1, 1923	22,500		4.875		109,687.50
December 10, 1925	23,370		17.25		403,132.50

66. The stock rights distributed to the plaintiff and its subsidiary on May 16, 1922 were exercised on June 26, 1922; those distributed on November 23, 1923 were exercised on

December 1, 1923; and those distributed on October 22, 1925 were exercised on December 10, 1925.

67. The lower of the aggregate value of the distribution spread and the aggregate value of the exercise spread for each of the sets of rights which were exercised were as follows:

Distribution date	Exercise date	Aggregate value of lowest spreads
May 16, 1922	June 26, 1922	$163,125.00
October 23, 1923	Dec. 1, 1923	109,687.50
October 22, 1925	Dec. 10, 1925	397,290.00
Total		670,102.50

V. LEASED LINE SUBSIDIARIES

68. Since January 1, 1936, plaintiff has operated under leasehold agreements all the properties of the Oregon Short Line Railroad Company, the Los Angeles & Salt Lake Railroad Company, and The St. Joseph & Grand Island Railway Company, hereinafter the "three roads" or the lessor corporations. Plaintiff entered into the leases in order, among other things, to reduce bookkeeping and other costs. It sought to eliminate intercompany accounting and to reduce the number of reports required to be made to state and federal authorities. *Union Pacific R. Co. Unification*, 189 ICC 357, 358–59, 363 (lines 21–23), 365 (lines 26–30) (1933); 207 ICC 543, 544–45 (1935).

69. During the years here in question, plaintiff accounted, for Interstate Commerce Commission and federal income and excess profits tax purposes, for all items of income and expense resulting from the operation by plaintiff of the properties of the three roads.

70. During the taxable year 1942, plaintiff included in its accounts and reported in its federal income and excess profits tax returns all items of income and expense resulting from the operation of the aforesaid properties of the three roads.

71. At all times material hereto plaintiff has owned 100% of the capital stock of Oregon Short Line Railroad Company, 50% of the capital stock of Los Angeles & Salt Lake Railroad Company (the remaining 50% being owned by Oregon Short Line Railroad Company), and approximately 99% of the capital stock of The St. Joseph & Grand Island Railway Company.

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Findings of Fact

72. On its excess profits tax return for 1942, plaintiff treated its stock in the three lessor corporations as inadmissible assets having as their basis the following amounts:

Oregon Short Line Railroad Company	$100,000,000.00
Los Angeles & Salt Lake Railroad Company	2,500,000.00
The St. Joseph and Grand Island Railway Company	5,629,266.19
Total	108,129,266.19

The only change made by the Commissioner of Internal Revenue in the treatment of these items for the purposes of the inadmissible asset adjustment was to reduce the basis of the Oregon Short Line stock to $85,140,589.76. Plaintiff's basis for that stock is dependent upon the resolution of count 5.

73. In computing its admissible assets for purposes of determining its excess profits tax credit based on equity invested capital for the taxable year 1942, plaintiff in its claim for refund claimed the aforesaid aggregate amount of $108,129,266.19 was includible therein.

74. Throughout 1942, plaintiff owned 1,000,000 shares of Oregon Short Line common stock, of which 273,507 shares were acquired prior to June 30, 1908, and the balance of 726,493 were acquired on November 10, 1910. As of June 30, 1908, plaintiff owned 100 percent of the outstanding stock. The acquisition in 1910 was of additional stock issued by the Oregon Short Line. Throughout 1942, plaintiff owned 125,000 shares of Los Angeles & Salt Lake common stock and the Oregon Short Line owned a like amount, plaintiff having acquired its stock in 1921 and the Oregon Short Line having acquired its stock in the fiscal year ended June 30, 1907. Plaintiff's stock in The St. Joseph and Grand Island was as follows on the indicated dates:

	Sept. 30, 1917	June 15, 1922	Dec. 31, 1942
1st Preferred	48,602.89	53,481.89	54,613.8903
2nd Preferred	33,597.79	34,597.79	34,896.2958
Common	45,483.00	45,719.00	45,900.0000

During 1942, plaintiff did not hold any of its stock in the three lessor corporations primarily for sale to customers in the ordinary course of its trade or business. During 1942,

plaintiff was not a dealer in securities, holding them for sale to customers.

75. All of the leases were approved by the Interstate Commerce Commission in opinions reported at 189 ICC 357 and 207 ICC 543.

76. Since January 1, 1936, plaintiff has also operated all of the properties of the Oregon-Washington Railroad & Navigation Company under a lease similar to those made with the three lessor corporations described above. All of the stock of Oregon-Washington was, during 1942, owned by Oregon Short Line Railroad Company.

77. During 1942, plaintiff had outstanding non-interest-bearing advances to the Oregon-Washington Railroad & Navigation Company and the Los Angeles & Salt Lake Railroad Company, the advances to the former ranging from about $44.6 million to about $45.7 million, and the advances to the latter ranging from about $25.7 million to about $27.3 million.

78. For 1940, 1941, 1943, 1944, and 1945, plaintiff and the lessor companies as well as other subsidiaries filed consolidated excess profits tax returns.

79. Each of the four lessor corporations incurred an income tax but no excess profits tax liability for 1942. The income tax was paid by plaintiff pursuant to the terms of the leases.

80. During 1942, the four lessor corporations owned the following shares of stock which were not leased to plaintiff:

Owner	Stock owned	Number of shares owned	Number of shares outstanding
Oregon Short Line	Oregon-Washington Railroad and Navigation	500,000	500,000
	Los Angeles & Salt Lake	125,000	250,000
	Des Chutes	1,000	1,000
	Yakima Valley	10,000	10,000
Oregon-Washington Railroad & Navigation, a subsidiary of Oregon Short Line.	Camas Prairie Railroad	500	1,000
	Northern Pacific Terminal Co.	12,000	30,000
	Cowlitz, Chehalis & Cascade Ry.	699.7	4,250
Los Angeles and Salt Lake	Las Vegas Land and Water	500	500
	Union Pacific Stage Co	30	30
	Utah Parks	250	250
	Overland Terminal Warehouse.	1,150	1,150
St. Joseph and Grand Island	St. Joseph Terminal Railroad	1,500	3,000
	St. Joseph Union Depot	10	10

81. Since the operation of the leasehold agreements began on January 1, 1936, no dividends have been paid to plaintiff with respect to its stock in the lessor corporations.

82. Under the lease with the St. Joseph and Grand Island, plaintiff agreed to pay as part of the rent certain dividends on the stock of the lessor in the hands of the public. The lease further provided that during the term of the lease the plaintiff waived all rights to dividends out of the rentals payable thereunder.

83. The leases with the Oregon Short Line and the Los Angeles and Salt Lake contained no provision prohibiting or restricting the payment of dividends by the lessor to the plaintiff.

84. As of December 31, 1941, earnings and profits accumulated after February 28, 1913, amounted to approximately $1.9 million for the Los Angeles and Salt Lake and $4 million for The St. Joseph and Grand Island. As of December 31, 1941, the Oregon Short Line had an earnings and profits deficit for the period beginning March 1, 1913. For the calendar year 1942, all three lessors had earnings and profits from which dividends to plaintiff could have been paid. (This is based on the fact that each of the lessors incurred an income tax liability for 1942, as indicated above in finding 116.) The income source of such dividends could have been the stock described in finding 80.

85. The plaintiff acquired and held the stock in the three roads for a business purpose, in connection with the conduct of its railroad operations, and only incidentally as an investment or capital asset.

VI. INTEREST ON 1948 AGREEMENT

86. Pursuant to the provisions of Section 321(a) of the Transportation Act of 1940, Government-owned materials transported in 1942 for military use were eligible for the preferential land-grant freight rates prescribed by the several Granting Acts and Equalizing Agreements.

87. During the taxable year 1942, plaintiff transported substantial quantities of war-connected materials for the Government. Many of these shipments were of a secret nature, their contents being unknown to plaintiff at the time of haulage. Other shipments contained new commodities for which freight rates had not yet been established pursuant to the Land Grant and Equalization Agreements.

88. Where reasonable doubt existed as to the true nature of a particular shipment, plaintiff charged the Government the full commercial tariff rate. These charges were paid in full by the various Government shipment departments and agencies. Plaintiff accrued the total amount of these charges as income during the year of carriage, and reported them in its federal tax returns for the taxable year 1942.

89. Upon audit in years subsequent to the taxable year 1942, the General Accounting Office determined that a substantial amount of the charges exceeded the proper land grant freight rates provided for the materials so shipped. The excess rates so determined were disallowed by the General Accounting Office, and plaintiff was required to, and did refund the excess charges to the Government.

90. With respect to the taxable year 1942, plaintiff was required to, and did make refunds to the Government of the aforesaid excess charges in the aggregate amount of $12,801,330.24 during the taxable years ended December 31, 1943 through 1956, and the period ended August 31, 1957, inclusive.

91. During the taxable years ended December 31, 1943 through 1956, and the period ended August 31, 1957, inclusive, plaintiff deducted on its federal tax returns the entire amount of $12,801,330.24 so refunded. The amount of such refunds and deductions, the years in which made, as well as the tax applicable thereto, were as set forth below:

Amount refunded and deducted in federal tax returns		Tax applicable to amounts refunded	
Year in which refunded	Amounts refunded	Rate	Amount of tax
1943	$174,824.45	81	$141,607.80
1944	2,051,410.99	72	1,030,615.91
1945	5,208,886.04	85.5	4,453,170.06
1946	1,804,053.36	38	685,540.28
1947	693,098.08	38	263,377.27
1948	279,536.77	38	106,223.97
1949	125,073.16	38	47,527.80
1950	322,850.90	42	135,597.38
1951	330,929.77	50.75	167,946.86
1952	340,833.76	52	177,233.56
1953	331,929.62	52	172,603.40
1954	369,377.83	52	192,076.47
1955	88,216.90	52	45,872.79
1956	27,293.98	52	14,192.87
1957	23,514.63	52	12,227.61
Total	12,801,330.24		8,545,814.03
Received 1941; refunded 1942 (see fdg. 94)	72,335.30		
Grand total	12,728,994.94		

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92. Under date of November 29, 1948, the Commissioner of Internal Revenue sent the following letter to plaintiff, herein sometimes called the Land Grant Cutback Agreement or the Cutback Agreement:

Union Pacific Railroad Company
120 Broadway
New York 5, New York
Attention: L. J. Tracy, Controller

Gentlemen: Reference is made to your letter of November 1, 1948, in which you request that certain modifications be made to Bureau letter of September 22, 1948, granting your company permission, subject to your agreement to the adjustments and conditions set forth therein, to allocate for Federal income tax purposes the repayments of certain excessive transportation charges to the years in which such charges were included in taxable income.

The information submitted in your letters of July 22, and November 1, 1948, is to the following effect:

Under section 321(a) of the Transportation Act of 1940, materials which were owned by the Government and were moving for military or naval use were entitled to reduced freight rates in accordance with land grants or equalization agreements. Section 322 of such act provides for the payment of transportation charges as presented but reserves the right to the Government to deduct the amount of any overpayment from any amount subsequently found due the carrier.

Beginning in 1941 and continuing throughout the war years and in 1946, your company transported large quantities of property for the several Government departments and agencies. In some cases the facts necessary to determine whether the property was eligible for net land grant rates were not available and were not disclosed for security reasons. In other cases the commodities were new and without precedent. Where there was reasonable doubt as to the application of net land grant rates, your company billed the Government initially on the basis of full commercial tariff rates, and the bills were paid by the disbursing officers of the several departments and agencies. Subsequently, the General Accounting Office upon audit disallowed transportation charges in excess of net land grant rates on a considerable volume of traffic and has made or is making demand for refund or effecting repayment by deduction from other amounts currently due your company.

Due to the arrearage in the work of General Accounting Office there has been a time lag of several years between the payment of the initial bills and the recoupment of the alleged excess charges. Your company has included the full amount of revenues received in its taxable income of the years in which accrued, and amounts repaid have been treated as reductions of taxable income for the years in which repaid. As a result of the delay in the audit of the transportation bills your company has reported large amounts of revenue in years when it was subject to high excess profits tax rates while the repayments have extended into post war years when tax rates are lower.

The statement submitted with your letter discloses that repayments in the amount of $38,424,471.15 have been made as of December 31, 1947, which are applicable to the years 1941 to 1947, inclusive. You state that your company paid excess profits taxes for each of the years 1942 to 1945, inclusive, had an unused excess profits carry-over from 1940 and 1941 to 1942, and was within the 80 percent overall limitation in 1944.

You suggest that it would simplify the adjustment if June 30, 1948, were agreed upon as a cut-off date for the year 1941. The 1941 adjustment would be closed out with repayments up to and including June 30, 1948, and any repayments arising after that date applicable to 1941 would be deductible in the year in which made.

Section 43 of the Internal Revenue Code provides, in part, as follows:

> "The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *"

The facts presented by you show conclusively that by reporting the transportation charges as income on the accrual basis and deducting the repayments in the year in which repaid, the taxable income for the years involved is not clearly reflected; and thus, a large net tax is incurred due to the high tax rates during the war years.

In view of the facts and circumstances presented, permission is granted under the authority conferred in section 43 of the Internal Revenue Code to allocate, on the

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terms and conditions hereinafter stated, repayments heretofore or hereafter made of excessive transportation charges of the class described above to the years in which such charges were included in taxable income. However, the allocation of any such repayments of excessive transportation charges to any year shall be made only to the extent the refund or credit of the overpayment of income and/or excess profits tax, if any, resulting therefrom is not prevented for any reason, and the deficiency, if any, of income and/or excess profits tax resulting therefrom may be assessed.

In this connection, it is understood that you agree, as follows:

1. All amounts received by you as transportation charges from the Federal Government Departments and Agencies shall be included in taxable income on the accrual basis.

2. All refunds of transportation charges made by you to the Federal Government shall be allowed as deductions in the year or years in which such transportation charges were included in income, and any deductions claimed in the year or years such refunds were made will be disallowed. This paragraph applies only to cutbacks on account of transportation charges in excess of land grant and reclassification rates, which were not contested or in controversy.

3. The amount of interest on refunds of income and excess profits taxes resulting from these adjustments shall be allowed only to the extent of, and limited to, the amount of interest on deficiencies resulting from these adjustments.

4. You will execute any such waivers under section 276 (b) of the Internal Revenue Code as may be requested to protect the Government's interests with respect to deficiencies for any of the years involved.

The adjustments agreed to above will not include any items which are the subject of presently pending claims filed on behalf of the United States by the Attorney General before the Interstate Commerce Commission for refunds from the railroads, including your company, for excessive charges for the transportation of war-time freight.

In regard to a cut-off date for any one of the years in question, a date which is mutually agreeable to the internal revenue agent in charge and your company will be acceptable to this office subject to the determination upon post review that the repayments made subsequent to that date which are applicable to the particular year are comparatively negligible in amount and that the deduc-

tion of such repayments in the year or years accrued will not distort income.

In any of the foregoing circumstances in which the repayments cannot be allocated to the prior years, they will be deductible for the year in which the repayments accrue.

This letter supersedes Bureau letter of September 22, 1948.

Notification from you of your agreement with the foregoing will constitute authority for disposition of the issue for the years involved. It is requested that such notification be submitted in duplicate.

Please reply on or before December 15, 1948, for the attention of IT:P:CA:ECH.

Very truly yours,

(Signed) GEORGE J. SCHOENEMAN
Commissioner

93. By letter dated December 14, 1948, plaintiff notified the Commissioner of its assent to the foregoing letter, the Land Grant Cutback Agreement.

94. During the audit of plaintiff's tax returns for 1942, plaintiff submitted to the Revenue Service statements showing the refunds for 1943 through 1957 listed in finding 91, as well as a refund of $72,335.30 made in 1942 of overcharges received from the Government in 1941. Copies of these statements were included in the revenue agent's report of December 12, 1957. Representatives of the plaintiff advised Revenue Agent Stortz that additional freight charges totalling $23,514.63 received from the Government in 1942 were refunded during the period beginning January 1, 1957, and ending August 31, 1957. Mr. Stortz verified this information, accepted it as correct, allowed as deductions for 1942 the amounts totalling $12,801,330.24, shown in finding 91, and disallowed for 1942 the deduction of $72,335.30 for refunds made in 1942 of overcharges received from the Government in 1941. These adjustments, which resulted in a net additional deduction of $12,728,994.94, were not disturbed by the Appellate Division in its final determination of plaintiff's tax liability for 1942.

95. The deductions claimed by plaintiff in the amount of $12,801,330.24 on account of refunds made during each of the taxable years ended December 31, 1943 through 1956 and the period ended August 31, 1957, have all been disallowed in

Revenue Agents' Reports covering said years pursuant to paragraph 2 of the aforesaid Cutback Agreement.

96. None of the deficiencies attributable to the disallowances referred to in finding 95 have been assessed to date, the years being still open for assessment on waivers.

97. On or about June 15, 1943, the plaintiff timely filed its Corporate Income and Declared Value Excess Profits Tax Return (Form 1120) for the calendar year 1942 showing the following liabilities:

Corporate Income Tax	$38,406,399.73
Declared Value Excess Profits Tax	72,182.99
	38,478,582.72

These amounts were assessed and payments with respect to the assessments were received by the defendant as follows:

March 15, 1943	$9,329,213.94
March 15, 1943	689,002.56
June 15, 1943	9,221,074.86
September 14, 1943	9,619,645.68
December 15, 1943	9,619,645.68

98. On July 16, 1946, a subsequent assessment was entered and payment made for corporate income tax in the amount of $10,696.86 and interest, to that date, in the amount of $2,141.13, or a total of $12,837.99.

99. After the completion of the audit of the plaintiff's 1942 Corporate Income Tax and Declared Value Excess Profits Tax Return (Form 1120), the plaintiff received, on September 21, 1960, a Notice of Adjustment (relating to such 1942 return) together with a check for $7,793,219.55. The notice of adjustment explained the computation of the refund as follows:

	(1) Income tax	(2) Assessed interest	(3) Declared value excess profits tax	Totals of 1, 2 and 3
Assessed in June 1943	$38,406,399.73	----------	$72,182.99	$38,478,582.72
Assessed on July 16, 1946	10,696.86	$2,141.13	----------	12,837.99
Total assessed	38,417,096.59	2,141.13	72,182.99	38,491,420.71
Less: Correct liability	30,481,263.37	None	None	30,481,263.37
Overassessments	7,935,833.22	2,141.13	72,182.99	8,010,157.34
Less: Overassessment previously allowed	----------	----------	58,720.19	58,720.19
Overassessment allowed	7,935,833.22	2,141.13	13,462.80	7,951,437.15

The total assessment was credited or refunded to the taxpayer as follows:

Total Overassessment	$7,951,437.15
Credited Toward Deficiency in Excess Profits Tax	4,206,773.93
Refund of Tax to Taxpayer	3,744,663.22
Interest on Refund	4,048,556.33
Total Amount Refunded	$7,793,219.55

The adjustment for railroad cutbacks did not alter plaintiff's income tax liability because the reduction in net income was completely offset by the reduction in the Section 26(e) credit for income subject to excess profits tax.

The overassessment of income tax in the amount of $7,935,833.22 (col. 1 above) was due to general adjustments and not adjustments on account of railroad cutbacks. Accordingly, neither the refund of $3,744,663.22 nor the $4,048,556.33 in interest paid on account thereof was attributable to railroad cutbacks.

100. The overassessment previously allowed in Declared Value Excess Profits Tax for the calendar year 1942 (referred to in the preceding finding) which was in the amount of $58,720.19, a credit, was applied against outstanding liabilities as of July 16, 1945 and refunded to the taxpayer as follows:

Against the Assessments of July 16, 1946:		
Tax	$10,969.86	
Assessed Interest	2,141.13	
		$12,837.99
Against Liability for St. Joseph & Grand Island R.R. Co. (Year—1942)		196.82
Refunded in Cash to Plaintiff		45,685.38
Total Overpayment Applied		58,720.19

In addition to the cash refund made to plaintiff in the amount of $45,685.38, the plaintiff received interest thereon in the amount of $9,178.87.

101. In addition to filing the Corporate Income and Declared Value Excess Profits Tax Return (finding 97), the plaintiff timely filed a Corporation Excess Profits Tax Re-

turn (Form 1121) for the calendar year 1942, indicating that no liability was due thereon. Anticipating a deficiency in excess profits tax, the plaintiff on December 1, 1944, paid over to the District Director $3,525,000, which was immediately assessed on December 12, 1944, together with interest in the amount of $361,745.90. The assessment of interest was satisfied from an additional payment made by plaintiff on December 1, 1944. On July 16, 1946, in response to plaintiff's application for a tentative amortization adjustment, the Commissioner refunded to plaintiff $694,754.62 in excess profits tax for 1942 with interest thereon in the amount of $68,742.63. As a result of this refund, the net assessment for excess profits tax left on the books and paid by plaintiff as of July 16, 1946, was substantially $2,830,245.38.

102. On audit of plaintiff's excess profits tax return for 1942, the Commissioner of Internal Revenue made a number of adjustments, including an adjustment for railroad cutbacks. After taking into consideration all of these adjustments, he determined a deficiency in excess profits tax for 1942 in the amount of $4,654,621.45. On September 16, 1960, he assessed this deficiency together with interest thereon of $300,639.16, for a total assessment of $4,955,260.61. This assessment was satisfied by a credit of $4,206,773.93 in income tax for 1942 (referred to above in finding 99) and a postwar credit of $748,486.68.

103. Certain additional computations were prepared by an auditor in the Audit Division of the Internal Revenue Service bearing on whether the interest restriction in the Cutback Agreement should be given effect in computing interest allowable to plaintiff. These additional computations showed first that the general adjustments made on audit, if taken alone, resulted in an income tax liability of $30,481,263.37, an income tax deficiency of $7,935,833.22, an excess profits tax liability of $18,807,391.15, and an excess profits tax deficiency of $15,977,145.77. The computations showed that the general adjustments and the adjustment attributable to railroad cutbacks resulted in an income tax liability of $30,481,263.37 (which was the same liability as determined in the first of the four computations above) and an excess profits tax liability of $7,484,866.83. Because the

latter was $11,322,524.32 less than the excess profits tax liability initially determined in the amount of $18,807,391.15, the computation showed $11,322,524.32 in the line for overassessments. Finally, the computations showed that all adjustments resulted in an income tax liability of $30,481,263.37, an overassessment of income tax of $7,935,833.22, an excess profits tax liability of $7,484,866.83, and an excess profits tax deficiency of $4,654,621.45. Because the income tax liability was not changed by the adjustment for railroad cutbacks, these computations showed that none of the income tax overassessment or overpayment was attributable to the cutbacks and thus that the interest allowable on this overpayment should not be restricted by reason of the interest restriction in the Cutback Agreement. Because the computed excess profits tax deficiency of $15,977,145.77 resulting from general adjustments was never assessed or paid, the amount of $11,322,524.32 was not a true overassessment or overpayment. As indicated in the preceding finding, the Commissioner assessed and collected the excess profits tax deficiency of $4,654,621.45 resulting from all audit adjustments.

104. The Revenue Service has not made any refund of income or excess profits tax for 1942 resulting from adjustments for railroad cutbacks. (The only refund made was for $3,744,663.22 in income tax which was attributable to general adjustments, as indicated in finding 99.)

105. In computing the interest on the overpayment of income tax of $7,935,833.22, the Commissioner of Internal Revenue did not reduce the interest allowable on account of the interest restriction contained in the Cutback Agreement. The interest restriction in the Cutback Agreement did not enter into that computation. Had the interest restriction been deleted from the Cutback Agreement, interest would have been computed in the same manner.

VII. 1898–1918 LAND SALES

106. Upon the acquisition of the properties of Union Pacific Railway Company pursuant to a plan of reorganization in 1898, plaintiff acquired, among other properties, various lands.

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Findings of Fact

107. On April 5, 1898, plaintiff caused the Union Pacific Land Company to be incorporated in Utah. Plaintiff caused the lands and rights derived from the land grant to the Kansas Pacific Railway Company to be transferred to the Union Pacific Land Company. The Union Pacific Land Company issued to plaintiff $100,000 par value of its common stock and $10 million par value of its bonds. The bonds were secured by a mortgage upon all of the Union Pacific Land Company's assets. Plaintiff pledged the Union Pacific Land Company stock and bonds as collateral under its first mortgage.

108. The lands and properties referred to in the preceding findings consisted of 6,577,000 acres of land in Colorado, Kansas, Nebraska, Wyoming and Utah.

109. As of June 30, 1919, the plaintiff owned lands for non-carrier purposes in Nebraska, Kansas, Colorado, Wyoming and Utah amounting to 971,348.64 acres.

110. Plaintiff's first mortgage provided that the net proceeds from the sales of lands covered by the mortgage, with the exception of lands used for railroad purposes, be set apart and held by the trustee as a cash improvement and equipment fund and such net proceeds from time to time be paid to plaintiff to reimburse it for expenditures for betterments, improvements, and equipment, exclusive of such expenditures that may have been charged to operating expenses as cost of maintenance. Pursuant to this provision, during the period February 1, 1898, through December 31, 1918, the trustee had the following receipts:

Source:	
(1) Proceeds from sales by plaintiff of land and equipment	$2, 381, 588. 36
(2) Principal of deferred payments, interest thereon, and other receipts from lands of plaintiff less expenses	10, 203, 367. 53
(3) Interest received from U. P. Land Co. with respect to its bonds	5, 713, 967. 20
(4) Amounts received from U. P. Land Co. in payment of its bonds	5, 067, 000. 00
(5) Interest on uninvested cash	26, 794. 13
Total	23, 392, 717. 22

From these receipts, during the aforesaid period, the trustee paid over to plaintiff $23,286,091.13.

111. On its books plaintiff credited the aforesaid net proceeds of $23,286,091.13 to its investment in road equipment account.

112. Of the $2,381,588.36 in items 1, proceeds of sales, in finding 110, $160,922.65 is attributable to the period March 1, 1913, to December 31, 1917. None of the $160,922.65 was reported as income or gain on plaintiff's federal income tax returns for 1913–1917. (The amount of $160,922.65 is the sum of $160,212.65, $450, and $260 shown on plaintiff's exhibit V, in column 6, for fiscal 1915 and 1916 and calendar 1917.)

113. Of the entire amount of $10,203,367.53 in item 2, in finding 110, the sum of $1,231,264.60 has already been included in plaintiff's accumulated earnings and profits. This was for interest on deferred payments, other receipts from land, a small amount of taxable gain for 1918, less expenses. The balance of $8,972,102.93 represents deferred payments from sales of land.

114. Of the entire amount of $10,203,367.53 in item 2, in finding 110, $1,893,601.30 is attributable to the period March 1, 1913, to December 31, 1917. None of the $1,893,601.30 was reported as income or gain on plaintiff's federal income tax returns for 1913–1917. Of the $1,893,601.30 attributable to March 1, 1913, to December 31, 1917, $375,974.45 has already been included in plaintiff's accumulated earnings and profits as part of the $1,231,264.60 referred to in the preceding finding.

115. The entire amount of $5,713,967.20 in item 3 in finding 110 has already been included in plaintiff's accumulated earnings and profits. Of the $5,713,967.20, $566,431.20 is attributable to the period March 1, 1913, through June 30, 1916. None of the $566,431.20 was reported as income or gain on plaintiff's federal income tax returns for 1913–1916.

116. Of the entire amount of $5,067,000 in item 4, in finding 110, $151,947 is attributable to the period March 1, 1913, to December 31, 1917. None of the $151,947 was reported as income or gain on plaintiff's federal income tax returns for 1913–1917.

117. Item 5, in finding 110, has been included in plaintiff's accumulated earnings and profits. The sum of $13,223.89 was attributable to the period March 1, 1913, to December 31, 1917. None of the $13,223.89 was reported as income or gain on plaintiff's federal income tax returns for 1913–1917.

118. Of the claimed addition of $23,286,091.13 to accumulated earnings and profits, $6,972,025.93 has already been allowed, consisting of $1,231,264.60 of item 2 and all of items 3 and 5 in finding 110.

VIII. UNAMORTIZED BOND DISCOUNT & EXPENSE

119. When a corporation issues its bonds for cash, the difference between the maturity value of the bonds and the cash received, plus the expenses of the bond issue, is known as "bond discount and expense."

120. The dollar amount of bond discount and expense is customarily charged off over the life of the bonds. The dollar amount which has not yet been charged off is known as "unamortized bond discount and expense."

121. When the issuer receives less for its bonds than face value, *e.g.*, $900,000 for $1,000,000 in face value of bonds, and the balance sheet would not balance as would be the case were the left side to show cash of $900,000 and the right side to show $1,000,000 in liabilities, the unamortized bond discount, in the example $100,000, is customarily placed on the left side of the ledger in order to make the balance sheet balance.

122. In computing its excess profits tax credit for 1942 and its unused excess profits tax credit carryovers from 1940 and 1941, plaintiff included in total assets the following amounts for unamortized bond discount and expense:

For 1940	$6, 164, 563. 35
For 1941	3, 948, 380. 60
For 1942	1, 413, 684. 59

The amounts for 1940 and 1941 are aggregate amounts for the plaintiff, Oregon Short Line Railroad Company, Oregon-Washington Railroad & Navigation Company, Los Angeles & Salt Lake Railroad Company and The St. Joseph and Grand Island Railway Company.

123. On audit of plaintiff's excess profits tax return for 1942, the Commissioner of Internal Revenue included un-

amortized bond discount and unamortized bond issuance expense in total assets in the following amounts:

	1940	1941	1942
Unamortized bond discount	$5,538,243	$3,547,226	$1,270,359
Unamortized bond issuance expense	626,320	401,155	143,326
Total	6,164,563	3,948,381	1,413,685

124. On its books, plaintiff had deducted from surplus, in the year of issuance of debt securities, the amount of bond discount and expenses incurred. On its books and on its balance sheet, therefore, plaintiff did not carry as an asset amounts for unamortized bond discount and expense. For income tax purposes however, bond discount and expense was amortized and deducted over the life of the bonds. *Helvering* v. *Union Pacific R.R.*, 293 U.S. 282 (1934). In computing plaintiff's consolidated accumulated earnings and profits for 1940 and 1941, and plaintiff's accumulated earnings and profits for 1942, the Commissioner of Internal Revenue followed the treatment of bond discount and expense claimed for income tax purposes; that is, he did not deduct the discount and issuance expense in the year the bonds were issued, but he amortized it in accordance with deductions allowed for income tax purposes. In these same computations, the Commissioner deducted from earnings and profits none of the amounts referred to in finding 123. These amounts were stipulated to be unamortized, that is, unamortized for tax purposes, being the balances of bond discount and expense remaining to be written off in future years over the life of the bonds.

125. To a potential buyer of the stock of a corporation which had for income tax purposes unamortized bond discount and expense, the amount of the discount and expense could have some value as a source of tax deductions for future years. To a potential buyer of the assets of a corporation, or on liquidation, its unamortized bond discount and expense would not have any value. Unamortized bond discount produces no income.

126. In the determination of the book value of corporate stock, a securities analyst would not treat unamortized bond discount and expense as an asset; he would treat it as an offset to surplus.

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Findings of Fact

IX. DISCOUNT AND PREMIUMS

127. For 1940 and 1941, plaintiff and its railroad subsidiaries, including the Oregon Short Line Railroad Company and the Oregon-Washington Railroad & Navigation Company, filed consolidated income tax returns and consolidated excess profits tax returns. For 1942, plaintiff filed a separate income tax return and a separate excess profits tax return.

128. In computing net income, plaintiff deducted, on its consolidated income tax returns for 1940 and 1941 and its separate income tax return for 1942, the following amounts for amortization of bond discount and expense, unamortized bond discount and expense for bonds reacquired, United States documentary stamp taxes, and call premiums to retire bonds:

Company	Annual amortization of bond discount	Unamortized discount—bonds reacquired	Documentary stamp taxes	Call premiums	Total	Year
UP	$60,939.68	$3,265,037.46	$81,602.00	$6,442,381.12	$9,849,960.26	1940
OSL	61,316.34				61,316.34	1940
O-WR&N	111,096.46				111,096.46	1940
UP	69,411.06		28,402.00		97,813.06	1941
OSL	61,316.34				61,316.34	1941
O-WR&N	111,096.46				111,096.46	1941
UP	71,097.36				71,097.36	1942
Totals	546,273.70	3,265,037.46	110,004.00	6,442,381.12	10,363,696.28	

129. On September 1, 1940, plaintiff called for redemption two series of bonds, both with a maturity date of June 1, 2008. The first consisted of 4 percent bonds issued in the years 1908, 1909, and 1910, at a discount and with issuance expense. To redeem these 4 percent bonds, plaintiff paid the face amount of these bonds plus a premium of $4,942,381.12. The second series consisted of 5 percent bonds issued in 1923 at a discount. To redeem these 5 percent bonds, plaintiff paid the face amount plus a premium of $1,500,000. The total of the call premiums, $4,942,381.12 and $1,500,000, $6,442,381.12 is shown in the preceding finding. At the time these bonds were redeemed, there was unamortized bond discount and expense of $2,741,201.39 on the 4 percent bonds and unamortized bond discount of $517,997.28 on the 5 percent bonds. The total of these two amounts of unamortized bond discount is $3,259,198.67.

130. In May 1936, plaintiff issued 35-year 3½ percent debenture bonds at a discount. In October 1936, plaintiff issued 34-year 3½ percent debenture bonds at a discount. In 1940, plaintiff purchased certain of these debenture bonds at par with moneys derived from a sinking fund and retired them. With respect to these bonds purchased and retired, there was unamortized debt discount of $3,489.59 as to the 35-year bonds and $2,349.20 as to the 34-year bonds. The total of these two amounts of unamortized bond discount, $5,838.79, when added to the total unamortized bond discount in the preceding finding, $3,259,198.67, comes to $3,265,037.46, the figure shown in finding 129.

131. On its excess profits tax return for 1942, in computing its excess profits net income for 1942 and its unused excess profits tax credit carryovers from 1940 and 1941, plaintiff did not treat as interest the amounts shown in finding 128, but it treated the indebtedness with respect to these amounts incurred as borrowed capital.

132. On audit of the returns for the years 1940 and 1941, the Commissioner of Internal Revenue did not disturb the action taken by plaintiff as described in these findings.

133. The $110,004 in finding 128 was deducted in full in the years the bonds were issued and was not amortized over the life of the bonds as bond issuance expense. Defendant does not contend that these deductions were for interest for purposes of section 711 (a) (2) (B).

X. DONATIONS AND CREDITS

134. (a) For the taxable years ended December 31, 1940 and 1941, plaintiff and its railroad subsidiary companies, set forth below, filed consolidated federal income and excess profits tax returns:

Oregon Short Line Railroad Company (OSL);
Oregon-Washington Railroad & Navigation Company (O-WR&N);
Los Angeles & Salt Lake Railroad Company (LA & SL);
The St. Joseph and Grand Island Railroad Company (St. J & GI);

Saratoga & Encampment Valley Railroad Company (S & EV);
Laramie, North Park & Western Railroad Company (L & NPW);
Des Chutes Railroad Company (D C);
Yakima Valley Transportation Company (Y V T).

(b) For the taxable year ended December 31, 1942, plaintiff and the named subsidiaries filed separate federal income and excess profits tax returns.

(c) Henceforth the plaintiff and its aforesaid subsidiaries will ordinarily together be called the plaintiff.

135. The issue is whether the transfers by nonstockholders to plaintiff, whose amounts appear in finding 138(a), may be included in equity invested capital in plaintiff's consolidated return for 1940 and 1941, to determine its unused consolidated excess profits tax credit carryovers from 1940 and 1941 to 1942, and in plaintiff's return for 1942, to determine its credit for 1942.

In terms of statutory language, the question is whether the transfers in question are "contributions to capital" within the meaning of § 718(a)(8) of the 1939 Code. The test is that laid down in *United States* v. *Chicago, Burlington & Quincy R.R., supra.*

136. In the years 1914 through 1942, there were literally thousands of instances in which plaintiff received from numerous transferors cash and other property which it treated as donations and grants in aid of construction. These amounts were recorded on the plaintiff's books, since July 1, 1914, in accordance with the Uniform System of Accounts as prescribed by the Interstate Commerce Commission, by debiting the investment account, with a concurrent credit being made to "Other Adjustment Credits," "Donations" or "Grants in Aid of Construction."

NOTE: Such words as "donations and grants" and "donor" in the stipulation of the parties and in these findings are words of convenience only, without any substantive significance, except where they appear in the historical facts as, e.g., in finding 136.

137. (a) On the balance sheets of plaintiff as of December 31, 1940, 1941 and 1942, the credit balances in the afore-

said accounts were included on the liability side. Beginning with the year 1943, these amounts were included on the asset side of the balance sheet as credit balances in the investment portion.

(b) The following is a summary of the transfers treated as donations and grants on the respective books and records:

Company	Period of time transfers received	Amount
UPRR	Jan. 1, 1919 to Dec. 31, 1942	$3,714,900.18
OSL	Jan. 1, 1919 to Dec. 31, 1941	1,545,141.15
O-WR&N	Jan. 1, 1919 to Dec. 31, 1941	4,098,537.73
LA&SL	July 1, 1914 to Dec. 31, 1941	1,584,081.80
St. J&GI	July 1, 1920 to Dec. 31, 1941	8,920.20
S&EV	Jan. 1, 1933 to Dec. 31, 1941	97,038.71
L&NPW	Jan. 1, 1927 to Dec. 31, 1941	4,350.87
DC	Jan. 1, 1920 to Dec. 31, 1941	1,292.18
YVT	July 1, 1914 to Dec. 31, 1941	5,919.39

138. (a) The amounts of the transfers which (except as otherwise explicitly mentioned) are in issue and the classes of facilities constructed with the cash and property transferred appear in Schedule 3 of the appendix hereto and are incorporated by reference.

(b) The significance of the Schedule 3 tables lies in the amounts stated and not in the captions of the columns. In the stipulation of the parties, the caption of the first column of the tabulation reads "donor." The term, as is noted in finding 136, was not intended to be one of legal consequence and is properly an alternative to "transferor."

(c) The transfers in issue, whose amounts appear in foregoing subparagraph (a), fall into seven classes, the first five by governmental transferors and the last two by private transferors.

The classes (and in parenthesis their amounts for the period ending December 31, 1939) are as follows:

(1) governmental transfers to relocate line on account of dams ($5,992,110 of the total of $9,798,364).

(2) governmental transfers to relocate line on account of highways and waterways ($251,669). This class is a consolidation of lines 2 and 3, "relocation line account, highways," and "relocation line account waterways," in the column "class of facility" in finding 138(a). The single item whose amount appears on line 3 is on examination found to relate more to highways than to waterways.

(3) governmental transfers for highway underpasses and other highway crossings ($1,673,375). This class is a merger,

as substantially identical, of the transfers in line 4, "underpasses account highways" and line 5, "highway crossings," in the column "class of facility" in finding 138(a).

(4) governmental transfers for spur or other tracks ($273,831).

(5) governmental miscellaneous transfers ($320,601).

(6) nongovernmental transfers for industry spurs and other tracks ($891,354) and

(7) nongovernmental miscellaneous transfers ($395,422).

139. The aggregate account balances with respect to the transfers set forth in finding 138(a), as of December 31, 1939, 1940, 1941 and 1942 were as follows:

Company	Dec. 31, 1939	Dec. 31, 1940	Dec. 31, 1941	Dec. 31, 1942
UPRRCo	$3,573,818.07	$3,487,843.24	$3,675,562.72	$3,657,028.59
OSL	1,165,989.37	1,179,189.14	1,231,914.16	----------
OWR&N	3,771,380.42	3,943,964.11	3,974,199.49	----------
LA&SL	1,167,794.33	1,161,726.50	1,402,394.60	----------
StJ&GI	9,008.72	8,920.20	8,920.20	----------
DC	1,549.06	1,292.28	1,292.28	----------
YVT	5,919.39	5,919.39	5,919.39	----------
S&EV	98,553.79	98,496.60	97,038.71	----------
L&NPW	4,350.87	4,350.87	4,350.87	----------
Total	9,798,364.02	9,891,701.23	10,401,592.32	3,657,028.59

140. The foregoing aggregate account balances as of the close of each of the years 1939, 1940, 1941 and 1942 represent facilities on hand as of the close of each of the respective years.

141. The aforesaid facilities in finding 138(a), representing the cash and other property transferred to plaintiff and its railroad subsidiaries, were held by plaintiff and its subsidiaries during the taxable years 1940, 1941 and 1942 for use in their trade or business for such years.

142. None of the transfers whose amounts appear in finding 138(a) were reported or taxed as income for federal income tax purposes, with the exception of the transfers specified in finding 145(a) as having been subjected to income tax.

143. In computing its excess profits tax credit for the taxable year 1942, and its consolidated excess profits tax credit for the taxable years 1940 and 1941, so as to determine its unused excess profits tax carryovers from 1940 and 1941 to 1942, plaintiff included in equity invested capital:

(a) In Accumulated Earnings and Profits

The entire credit balances for the transfers set forth

in finding 138(a), as of December 31, 1939 through 1941, inclusive; and

(b) In Total Assets

The entire credit balances for the transfers set forth in finding 138(a) as of December 31 plus one-half the aggregate net additions occurring during the next succeeding year. The aggregate net additions so included were determined by netting retirements occurring during the stated periods against additions occurring during such periods.

144. In the audit of plaintiff's consolidated excess profits tax returns for 1940 and 1941, and its separate excess profits tax return for 1942, the Commissioner of Internal Revenue excluded from equity invested capital the amounts referred to in finding 143, with the exception of the amounts set forth in finding 145(a).

145. (a) In the audit of plaintiff's returns for the taxable year 1942, the Commissioner of Internal Revenue treated the following transfers as includible in equity invested capital (either as a contribution to capital or as accumulated earnings and profits) and total assets of plaintiff's aforesaid railroad subsidiaries in the amounts as set forth below:

	Transferor	Transferee	Year	Subjected to income tax	Amount included for transfer
1.	Trustees of Citizens Right-of-Way Committee	OSL	1925	No	$240,421.01
2.	E. C. Bradley	OSL	1901	No	200,000.00
3.	Citizens Right-of-Way committee and/or individuals of Boise	OSL	1925	No	1,076.61
4.	Twin Falls Citizens Right-of-Way committee	OSL	1925	No	28,338.80
5.	Utah Copper Co	LA&SL	1924	In part	65,885.00
6.	Citizens Committee	S&EV	1928	No	100,000.00
7.	Unknown	OWR&N	1930	Yes	27,316.49
8.	Unknown	OWR&N	1931	Yes	56,917.11
9.	Unknown	OWR&N	1932	Yes	26,161.00
10.	Unknown	YVT	1915	Unknown	440.90
11.	Unknown	YVT	1922	Unknown	837.00

(b) The parties have agreed that plaintiff is not entitled to prevail with respect to item 1 in the foregoing subparagraph and with respect to a transfer by the United States Railroad Administration in 1932 involving $243,475.60. These transfers are not included in the amounts stated in finding 138(a).

(c) The parties have agreed that for the purposes of this proceeding items 7, 8, 9, 10 and 11 in subparagraph (a) above are not in issue and they were properly included in equity

invested capital. These items are included in the amounts stated in finding 138(a).

(d) Items 2, 3, 4, 5 and 6 in subparagraph (a), above, are included in the amounts stated in finding 138(a), and are in issue in this proceeding as offsets to count 17. See the findings following finding 173.

146. (a) The thousands of transfers in issue (appendix, Schedule 3, finding 138(a)) have by agreement been reduced to 56 representative transfers, which appear in Schedule 4 of the appendix hereto.

(b) The parties have further agreed, in the interchange of proposed and counterproposed findings and objections thereto, upon individual transfers to represent the several classes of transfers in issue described in finding 138(a).

147. *Class 1—Governmental transfers to relocate line on account of dams.* (a) The two transfers representative of this class were made by the Federal Government to the Oregon-Washington Railroad Company in connection with the construction of the Bonneville Dam on the Columbia River in Oregon.

The first took place in the years 1935–1943 and involves $2,359,747. This was the cost (paid by the Government) of relocating a portion of the line which was going to be submerged as the result of the construction of the dam.

The second took place in the years 1938–1941 and involves $1,200,729. This was part of the $1,531,000 paid by the Government to the railroad for flowage rights. The railroad agreed to grant the rights for this price in order to obviate the exercise of the right of eminent domain threatened by the Government. The railroad used the funds to relocate and protect parts of its line due to the raising of the level of the river.

(b) It is concluded that these transfers, exchanges of values and simple replacements of existing facilities which left the transferee railroad no better off than before, did not materially contribute to the production of further or additional income by the transferee railroad. The transfers were, also, a direct payment for a specific, quantifiable benefit provided for the transferor by the transferee. *See United States* v. *Chicago, Burlington & Quincy R.R., supra.* Also,

the transferors sought and obtained a direct benefit to themselves, and did not intend to confer a benefit on the transferee.

The transfers did not effect a contribution to the capital of the transferee railroad, the plaintiff.

148. (a) *Class 2—Governmental transfers to relocate line on account of highways.* The transfer representative of this class was made by the City of Long Beach to the Los Angeles and Salt Lake, involving $240,000 for 1933–1935.

The contract for the transfer recites that the City was desirous of acquiring (a) the railroad's rights to operate its line on certain city streets, with a view to improving the streets, and (b) the right to use the railroad's drawbridge across the entrance to a harbor for pedestrian and vehicular traffic (and certain land on the approaches to the drawbridge), requiring the construction of a new highway for this purpose. For these rights, the City agreed to pay the railroad $460,000, later reduced to $240,000. The railroad agreed to relocate its line on a right-of-way it would acquire. The purpose of the transaction on the part of the transferor was to pay for the property rights acquired.

(b) It is concluded that the transfers in class 2 are essentially the same as those in Class 1, *supra*, and, did not effect a contribution to the capital of the transferee railroad, the plaintiff.

149. *Class 3—Governmental transfers for highway underpasses and other highway crossings.* (a) The two transfers representative of this class are:

1. A transfer involving $152,316, made in the years 1934–1938 by the State of Idaho to the Oregon Short Line Railroad Company. The state and the City of Pocatello, under a contract with the railroad, replaced a viaduct with a subway to carry the highway traffic under the tracks of the railroad. Under the contract between the state, city, and railroad, the railroad granted the state the right to remove the viaduct and to construct the subway; granted the city the right to maintain and use the subway; and agreed to undertake, at the expense of the state, portions of the work involved. The state agreed to pay for the removal of the viaduct and the construction of the subway. All of the construction was per-

formed by the railroad at a total cost of $155,079.45, of which $152,316 was paid for by the State of Idaho.

Article I of the contract between the parties grants to the City the right to maintain and use the subway and street under the tracks, subject to the "continuing right and obligation of the Railroad Company to use and maintain its said right of way in the performance of its public duty as a common carrier." Article 8 provides that the City shall maintain the subway structure, except the track-supporting structure, and that "The Railroad Company shall, at its own expense, maintain the track-supporting structure portion of the subway."

There is no explicit reference to federal financing in the papers in the record concerning this transfer. In the papers on other transfers in this class for similar facilities, however, it appears that such transfers were federally financed. One of them, a transfer of $147,962 for a subway under the line at Lawrence, Kansas in 1938, is described as a grade crossing project financed under the Federal Aid Appropriation Act of June 16, 1936 (Public Resolution 686, 74th Congress) in accordance with the Federal Highway Act, which provided for the elimination of hazards to life at railroad grade crossings. By the contract between the parties, the railroad was obligated to maintain a specified part of the improvement. The contract for a transfer of $120,088 (federally financed) for a subway under the line in Denver, Colorado in 1941 imposes upon the carrier the obligation to "forever maintain" specified portions of the improvement.

2. The second transfer representative of this class involves $400 paid by Jefferson County, Kansas in 1921 to the plaintiff for the construction of a new highway crossing at Walnut Street in Williamstown, Kansas. The County Commissioners ordered the work and issued a warrant for it. The work consisted of grading and the supply of oak planks and one highway crossing sign, and other materials and labor. No formal agreement appears to have been made, and nothing appears as to any obligation of the railroad to maintain the improvement.

(b) It is concluded that the transfers in class 3 are substantially identical with those considered in *United States* v.

Chicago, Burlington & Quincy R.R., supra, and did not effect a contribution to the capital of the transferee railroad, the plaintiff.

150. *Class 4—Governmental transfers for spur or other tracks.* (a) The transfer representative of this class involves $9,564 paid by the State of Colorado and the City of Denver to plaintiff in 1939 as the cost of plaintiff's share of work jointly performed by several railroads to eliminate grade crossings at the Union Stockyard in Denver by the construction of a vehicular subway below the railroad line. The transferor governments were seeking to replace the grade crossings with a subway to carry vehicular traffic under the tracks of several railroads in the stockyard. Plaintiff and The Colorado and Southern Railway Company jointly owned a portion of the trackage involved. The work was divided among the roads involved and plaintiff's share of the work was some connecting track and extensions to the industry spur. (Hence, apparently, the title of category 4 as involving transfers for spurs.)

The project was to be financed from funds appropriated by the Federal Government, as appears from the agreement governing the project, which recites that funds described as "Works Program Grade Crossing Funds" provided under the Emergency Relief Act of 1935 (Public Resolution No. 11, 74th Cong.) are available for the purpose of eliminating the existing hazard to life of railroad crossings and that the project in question was being undertaken in the interest of public safety and convenience.

The contract provides that the City shall have the duty to maintain, repair and renew the new work on the roadway of the new subway and that the Burlington and the Colorado and Southern Railroads and the stockyard company shall have the duty for the subway structure. It does not appear what are the contractual relations between the Colorado and Southern on the one hand and plaintiff on the other, the joint owners of the trackage by reason of which the two were involved in the project.

(b) It is concluded that the transfers in class 4 are substantially identical to those considered in *United States* v. *Chicago, Burlington & Quincy R.R., supra*, and did not ef-

fect a contribution to the captial of the transferee railroad the plaintiff.

151. *Class 5—Governmental miscellaneous transfers*—(a) Transfers 1–6 of the 10 transfers representative of this class, totalling $13,679 or 87.2 percent of the total for the 10 transfers of $15,693, are as follows:

1. $145. In 1938 plaintiff leased a portion of its right-of-way to the Kansas City Prison for use as a pasture, under a lease providing that the lessee was to move the present right-of-way fence at its expense. The actual work for the facility involved, a "hog-tight" fence for the prison farm, was done by the plaintiff at the cost of the lessee. The labor was furnished by the prison and $145 worth of materials were used.

2. $62. The plaintiff was assessed $630, presumably by municipal authorities, for the installation of a street light system on Grand Street at the railroad station in Pullman, Washington. The plaintiff then billed the State of Washington $62 as the latter's proportion of the assessment under the easement contract covering encroachment of the state's highway on the railroad's grounds at Pullman. The contract is not in the record.

3. $6,999, for the installation in 1938 of an underground cable and aerial cable for telephone and telegraph lines, replacing open wire lines, paid for by the Los Angeles Bureau of Power and Light. There is no contract in the record covering this transfer.

4. $456. In 1939 the town of Cornish, Utah, desired to furnish water to the stockyard at the railroad station and by contract obtained from plaintiff the right to construct and maintain a water pipeline under the plaintiff's line to the stockyard. Apparently by further agreement, the plaintiff agreed to furnish the material and the town agreed to bear the labor costs, which it did by furnishing "W.P.A. labor" valued at $456.

5. $3,080 for the installation in 1924 under plaintiff's roadbed and tracks of an irrigation waterway, comprising a cast iron pipe syphon, concrete end walls and a 4′ x 8′ ditch, paid for and to be maintained by the Indian Service of the

Federal Government in connection with the operation of an irrigation system for Indians.

6. $2,937 for the construction in 1938 of a culvert under the right-of-way for the drainage of waste irrigation water, paid for by the United States Reclamation Service.

(b) It is concluded that 87.2 percent of the transfers in this class, essentially expenditures by a tenant or easement owner for his own benefit, left plaintiff no better off than before. The transfers were under *United States* v. *Chicago, Burlington & Quincy R.R., supra*, peripheral to plaintiff's business and did not materially contribute to the production of further income by the railroad. Also, the transferors sought and obtained a direct benefit to themselves, and did not intend to confer a benefit on the transferee. The transfers did not effect a contribution to the capital of the transferee railroad, the plaintiff.

(c) Transfers 7–9 of the 10 transfers representative of this class, totalling $1,885 or 12 percent of the $15,693 of the 10 transfers, are:

7. $437, paid by the State of Colorado in 1934 for rearrangement of telegraph and signal lines required in connection with the construction of a highway viaduct by the state.

8. $1,443 for two searchlight signals at a grade crossing in the City of Los Angeles, paid by the State of California in 1940 with funds allocated to the state by the Federal Government for the purpose of installing additional grade crossing protection.

9. $5, the cost of four metal plates reading "Stop," provided by the State of Colorado in 1928 for use in "Stop" signs to be installed at two highway crossings.

(d) It is concluded that 12 percent of the transfers in this class are substantially identical with those considered in *United States* v. *Chicago, Burlington & Quincy R.R., supra*, and did not effect a contribution to the capital of the transferee railroad, the plaintiff.

(e) The last of the 10 transfers representative of this class is $129, or 0.8 percent of the total of $15,693 of the 10, and was the value of the W.P.A. labor caused to be furnished by the town of Oakley, Kansas, in 1938 to construct four new sanitary privies, notice having been given the railroad by the

town to abate a nuisance in the form of unsanitary privies. While the data is scanty, it is concluded as a matter of fact that the dispositive transferor was the town and that it was utilizing, in a manner it deemed appropriate, W.P.A. labor available to it for a purpose generally advantageous to the community and beyond its own regular functions, and that the town intended to confer a benefit upon the plaintiff.

(f) It is concluded that 0.8 percent of the transfers in this class replaced existing facilities with new and better ones which the plaintiff would have been required to construct from capital funds had the transfers not taken place, and thus the transfers resulted in a benefit to the transferee in an amount commensurate with value in that they enabled plaintiff to avoid a capital expenditure to the value of the assets transferred, the sum whose expenditure was avoided was employed in the production of further or additional income. Also, the transferors did not seek or obtain a direct benefit to themselves, but rather an indirect benefit to the community at large, thereby manifesting a purpose to enlarge the capital of the transferee. The transfers effected a contribution to capital of the transferee railroad, the plaintiff.

152. *Class 6—Nongovernmental transfers for industry spurs and other tracks.* (a) The three transfers representative of the majority of the transfers in this class, by shippers, are as follows:

1. $1,154 paid by the Republic Chemical Works to the plaintiff in 1919 for a spur track of 975 feet. The track was requested by Republic to obtain rail service to its potash plant.

2. $6,976 transferred by the Utah Idaho Sugar Company to the Oregon Short Line in 1919 for a spur track to serve the former's factory. In order to obtain rail service, the sugar company transferred to the railroad land for the spur track right-of-way, performed the necessary grading, and paid for the installation of nine culverts.

3. $577 transferred by the Amalgamated Sugar Company to the Oregon Short Line in 1936 for a 920-foot beet loading track. The sugar company sought the loading track to serve a new beet-raising territory it was developing. The

sugar company performed the necessary grading and paid for the labor required for the construction of the track.

Such transfers to railroads by shippers are compensation—"a direct payment for a specific quantifiable service provided for the transferor by the transferee" (*United States* v. *Chicago, Burlington & Quincy R.R., supra*). Also, the transferors sought and obtained a direct benefit to themselves, and did not intend to confer a benefit on the transferee. The transfers did not effect a contribution to the capital of the transferee railroad, the plaintiff.

(b) The two transfers by nonshippers among the transfers representative of this class are:

1. $7,770 paid by the Utah Power and Light Company. In 1927 the company, by agreement with plaintiff, planned to construct a reservoir which would encroach on the plaintiff's right-of-way, necessitating the underpinning and strengthening of an embankment and connected improvements. By contract the parties agreed that the work would be done at the expense of the power company and would become the property of the plaintiff.

It is concluded that such transfers are substantially identical with the transfers in class 1 and the 87.2 percent of the transfers in class 5. They did not effect contributions to the capital of the transferee railroad.

2. $1,997, the cost of work borne by the Southern Pacific Railroad Company. The lines of plaintiff and the Southern Pacific crossed at a point in San Bernadino County, California. Under agreements dating from 1902 the two roads maintained a joint crossing and manually operated interlocking plant and gates. In 1930 the California Railroad Commission ordered the replacement of the equipment with an automatic interlocker. The two roads negotiated and agreed, presumably in the light of the provisions of their existing agreements, upon the proportion of the cost each would bear. The $1,997 transferred to plaintiff by the Southern Pacific Railroad is the product.

It is concluded that such transfers, made pursuant to an earlier agreement between transferor and transferee, for a consideration flowing from transferee to transferor, are

closely similar to a "direct payment for a specific quantifiable service provided for the transferor by the transferee" (*United States* v. *Chicago, Burlington & Quincy R.R.*, *supra*). Also, the transferors sought and obtained a direct benefit to themselves, and did not intend to confer a benefit on the transferee. The transfers did not effect a contribution to the capital of the transferee railroad, the plaintiff.

153. *Class 7—Nongovernmental miscellaneous transfers.* (a) The transfers representative of this class are $536 paid by two lessees for street lights installed on the leased property; $92 paid by the owner of land on both side of the right-of-way for the construction of a private road crossing over the right-of-way and the installation of two right-of-way gates; $2,100 paid by the Laramie Stock Yards Company for the construction of feed racks in the sheep pens located on the plaintiff's land; $631 paid by the Beaverhead Water Company for the construction of a culvert to carry its irrigation ditch under the tracks; $126 paid by the Pacific Fruit Express Company for the repair and installation of an old car-body for storing charcoal heaters used by the Express Company; $354 as the value of a scale installed on Oregon Short Line property by the Big Hole Stockmen's Association for the latter's use in connection with the operation of its stock yards; $415 for a 22′ x 60′ covered vegetable platform located on plaintiff's property for the use of a lessee produce company; $444 paid by the Pacific Fruit Express Company for an electric power line constructed across the right-of-way to the express company's icing facilities; and $1,364 spent by Magnus Metal Company for the construction of a retaining wall on plaintiff's right-of-way, preliminary to raising the grade on an industry spur track which was to serve a new addition to the Magnus plant.

(b) It is concluded that such transfers are substantially identical with the 85.2 percent of the transfers in class 5. Such transfers do not effect contributions to the capital of the transferee railroad.

154. Pursuant to a contract of March 25, 1901, the Oregon Short Line Railroad Company agreed to build a railroad from its line in Idaho to the properties of the White Knob

Copper Co., and to transport over the railroad coal and coke to be used in the smelter to be erected by the Copper Co., at as favorable terms and rates as made to other parties under similar conditions, in consideration of which E. C. Bradley agreed to bring about the construction of the smelter and to pay the Oregon Short Line $200,000 in cash. Subsequently, these agreements were carried out, and the $200,000 was paid to the Oregon Short Line.

155. Bradley paid the $200,000 in order to obtain rail service for his smelter.

156. In computing plaintiff's excess profits tax liability for 1942, the Commissioner of Internal Revenue included the $200,000 received from E. C. Bradley in the Oregon Short Line's accumulated earnings and profits as of January 1, 1940 and January 1, 1941. The Commissioner also included the $200,000 in total assets for the Oregon Short Line for 1940 and 1941. (See finding 145(a), item 2.)

157. It is concluded that the transfer was a payment for a specific, quantifiable thing; also the transferor sought a direct benefit as a quid pro quo, and manifested no purpose to enlarge the working capital of the plaintiff. The transfer therefore did not effect a contribution to capital.

158. (a) During the year 1925, the Oregon Short Line acquired certain lands in Idaho in two transfers.

The first transfer consisted of land between Orchard and Boise, Idaho, acquired from a citizens right-of-way committee and/or individuals of Boise, Idaho. It was made pursuant to a contract of August 14, 1922, between the Boise Chamber of Commerce and the Oregon Short Line. The contract recites that the Chamber of Commerce has petitioned the railroad to build a railroad line from Orchard to Boise to connect with the existing line between Boise and Nampa, "the purpose of which is to provide through train service" for Boise. The railroad agreed to construct the line and to run through Boise four particular trains. The Chamber of Commerce agreed to (a) raise a fund to pay a portion of the taxes on the new line, (b) provide the right-of-way, (c) secure for the railroad the balance of the so-called Citizens

Right-of-Way Committee, and (d) obtain the necessary franchises.

(b) The transferors conveyed the land for the right-of-way to obtain better rail service for the City of Boise.

(c) The second transfer consisted of land for a new line from Rogerson, Idaho, to Wells, Nevada, acquired from the Citizens Right-of-Way Committee of Twin Falls, Idaho. It was made in connection with the construction of an extension of the rail line from Rogerson to Wells, a distance of some 94 miles; side tracks of about 13 miles; terminal facilities at Twin Falls and Wells; and an elevated crossing over the Southern Pacific line at Wells.

(d) The Citizens Right-of-Way Committee of Twin Falls conveyed the land to the railroad to provide more direct outlet for agricultural products of Southern Idaho to California markets, and to open up for tonnage shipments numerous copper mining properties adjacent to the new line.

159. In computing plaintiff's excess profits tax liability for 1942, the Commissioner of Internal Revenue included in the Oregon Short Line's accumulated earnings and profits as of January 1, 1940, and January 1, 1941, and its total assets for 1940 and 1941, the amounts of $1,076 and $28,338.80 relating respectively to the two transfers described in the foregoing finding. (See finding 145(a), items 3 and 4.)

160. It is concluded that the two transfers described in finding 158 were not payments for a specific thing or a service, were bargained for, resulted in a benefit to the transferee in an amount commensurate with their value, and the assets transferred were employed in the production of further or additional income. Also, the transferors did not seek or obtain a direct benefit to themselves, but rather an indirect benefit to the community at large, thereby manifesting a purpose to enlarge the capital of the transferee. The transfers effected contributions to capital.

161. In 1928, a citizens committee paid $100,000 to acquire the Saratoga and Encampment Railroad and transferred it to the Saratoga and Encampment Valley Railroad Company, a subsidiary of the plaintiff incorporated on May 5, 1928, in Wyoming, in consideration of plaintiff's promise to operate the railroad permanently.

162. Operation of the railroad referred to in the foregoing finding had been terminated earlier that year. The committee paid the $100,000 in order to obtain a resumption of rail service.

163. In computing plaintiff's excess profits tax liability for 1942, the Commissioner of Internal Revenue included this $100,000 in the Saratoga and Encampment Valley Railroad Company's accumulated earnings and profits as of January 1, 1940, and January 1, 1941, as well as its total assets for 1940 and 1941. (See finding 145(a), item 6.)

164. It is concluded that the transfer described in the two foregoing findings was essentially similar to the two transfers described in finding 160 and equally with those transfers effected a contribution to capital.

165. Pursuant to a contract of October 24, 1917, the Los Angeles & Salt Lake Railroad Co. relocated a portion of its main line, which adjoined the tailings dumps of the Utah Copper Co., near Garfield, Utah, and conveyed its abandoned right-of-way to the Copper Co., in consideration of which the Copper Co. conveyed land to the Los Angeles and Salt Lake for the new right-of-way, paid the expenses of the relocation, and paid to the Los Angeles and Salt Lake $19,760 for future maintenance of the relocated line plus $46,125 for the increased cost of operating the line.

166. The Utah Copper Company needed the additional land conveyed to it for expansion of its tailings dumps and the location of the Los Angeles and Salt Lake line of railroad prevented the acquisition in a useful way. To accommodate the former, the railroad company agreed to relocate its line on land furnished by the Copper Company, which was to pay all the expenses of the relocation.

167. In 1919, the Los Angeles and Salt Lake credited its property investment accounts with the sum of $196,564.27 as the cost of that part of its line of railroad which had been abandoned, charged to its property investment accounts the sum of $323,882.11 as the cost incurred by the Copper Company in the construction of the new and relocated section of railroad, and credited to its profit and loss account "606-

Donations," the sum of $127,317.84, being the difference between the above-mentioned amounts credited and debited, respectively.

168. In 1921, the Los Angeles and Salt Lake credited the sum of the cash payments of $19,760 and $46,125 to its account "Miscellaneous Credits," and in a later year transferred this sum to its account "606-Donations." On audit of the income tax return of the Los Angeles and Salt Lake for 1919, the Commissioner of Internal Revenue included in income the aforesaid amounts of $127,317.84, $19,760 and $46,125. The Los Angeles and Salt Lake conceded that the item of $19,760 was taxable income and sued for refund in the Court of Claims on the ground that the amounts of $127,317.84 and $46,125 were not taxable income.

169. In *Los Angeles & S.L.R.R.* v. *United States*, 86 Ct. Cl. 87, 21 F. Supp. 347 (1937), this court held that the amounts of $127,317.84 and $46,125 were not taxable income on the ground that the contract was designed "to make the plaintiff whole in the transaction and to insure it against loss."

170. In computing plaintiff's excess profits tax liability for 1942, the Commissioner of Internal Revenue included the aforesaid cash payments of $19,760 and $46,125 (but not the amount of $127,317.84) in the Los Angeles and Salt Lake's accumulated earnings and profits as of January 1, 1940, and January 1, 1941, and its total assets for 1940 and 1941. (See finding 145(a), item 5.)

171. The amounts of $127,317.84, $19,760, and $46,125 are included in the amounts received from private transferors set forth in finding 138(a) for the Los Angeles and Salt Lake Railroad as of December 31, 1939.

172. The defendant does not contest the treatment by the Commissioner of Internal Revenue of the amount of $19,760 described in finding 170 for the stated reason that the Los Angeles and Salt Lake has paid an income tax with respect thereto.

173. It is concluded that the transfer of $46,125 was substantially identical with the transfers in class 1 and equally with those transfers did not effect a contribution to capital.

Findings of Fact

XI. EQUITY INVESTED CAPITAL

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1. *Definition of the Issue*

174. The plaintiff's predecessor, The Union Pacific Railroad Company, sometimes herein called the predecessor, was incorporated on July 1, 1862, by the Act of July 1, 1862, c. 120, 12 Stat. 489. In 1880, when it was consolidated with the Kansas Pacific and Denver Pacific, its name was changed

to The Union Pacific Railway Company. The Company was in receivership between 1893 and January 31, 1898, and was succeeded by the plaintiff, as will appear. Both plaintiff and its predecessor are for convenience herein often called the "U.P."

175. Plaintiff, the Union Pacific Railroad Company, was incorporated July 1, 1897, under the general laws of the State of Utah, for the principal purpose of acquiring the property, rights and franchises of The Union Pacific Railway Company. In addition, plaintiff had the power to acquire the lands and land grants, and all rights with respect thereto, of The Union Pacific Railway Company or of its constituent companies, and to construct, purchase or otherwise acquire and operate branches, extensions and connecting or auxiliary lines.

176. As more fully set forth hereinafter, plaintiff acquired the property, rights and franchises of The Union Pacific Railway Company and certain of its constituent companies, including certain branch, extending, connecting and auxiliary lines.

177. Upon the conclusion of the receivership of its predecessor and pursuant to the reorganization plan, the plaintiff issued to the predecessor's reorganization committee, for money and property of the predecessor acquired by the committee, $90 million in 4 percent first mortgage bonds, 610,000 shares of common stock, par value $100, with an aggregate par value of $61 million, and 750,000 shares of preferred stock, par value $100, with an aggregate par value of $75 million, for distribution to the predecessor's stockholders and other claimants. The stock so issued—both the common and the preferred shares—is herein called the reorganization stock, and is the first of two blocks of stock whose valuation is the subject of the instant case.

178. During the fiscal year ended June 30, 1915, plaintiff cancelled 136 shares of its common stock, with a par value of $13,600, and 258 shares of its preferred stock, with a par value of $25,800, reducing the reorganization stock outstanding as of June 30, 1915, to 609,864 shares of common with a par value of $60,986,400 (609,864 shares at $100 par) and

749,742 shares of preferred with a par value of $74,974,200 (749,742 shares at $100 par).

179. Pursuant to an offer made by plaintiff, following the reorganization, to issue one share of its common stock, par value $100 per share, for one share of the common stock of the Oregon Short Line Railroad Company plus $3, plaintiff issued its common stock as follows:

Period of time:	*Number of shares of plaintiff's common stock issued*
January 26, 1899 to February 25, 1899	137,301
February 26, 1899 to March 4, 1899	68,650
March 5, 1899 to March 11, 1899	27,460
March 12, 1899 to June 30, 1899	31,642
July 1, 1899 to December 1, 1899	1,966
December 2, 1899 to June 30, 1900	3,688
July 1, 1900 to June 30, 1901	2,636
July 1, 1901 to June 30, 1902	50
July 1, 1907 to June 30, 1908	100
Total	273,493

The foregoing 273,493 shares will, either intact or minus 150 shares whose value has been agreed, herein be called the post-reorganization stock, and is the second of the two blocks involved in this case.

180. By other means, plaintiff acquired prior to June 30, 1908, an additional 14 shares of Oregon Short Line common. As of June 30, 1908, no shares of Oregon Short Line common were in the hands of the public; plaintiff owned the entire amount outstanding, having a par value of $27,350,700, and the Oregon Short Line owned $109,400 par value of its common stock.

181. On its excess profits tax return for 1942, plaintiff stated the money paid in for stock, or as paid-in surplus, or as a contribution to capital to be $321,834,100, or the par value of $100 per share for the 3,218,341 shares of common and preferred stock outstanding during 1942, of which 1,633,099 shares of common and preferred were originally issued in connection with the reorganization of the Union Pacific and the acquisition of the Oregon Short Line Railroad Company.

These 1,633,099 shares were comprised of the remaining outstanding reorganization stock, that is, (1) 609,864 of the 610,000 shares of common and 749,742 of the 750,000 shares of

preferred which had been issued as above-mentioned, pursuant to the reorganization plan, and (2) the 273,493 shares of common issued as above-mentioned between 1899 and 1908 to acquire the common shares of the Oregon Short Line Railroad Company.

In other words, plaintiff took the position in its tax return that the fair market value, when issued, of the then remaining outstanding shares of reorganization and acquisition stock, and thus that the fair market value, when issued, of each of the shares comprising the reorganization stock and the acquisition stock was its par value, $100 per share, with a total value of $163,349,300 for the originally issued 1,633,493 shares of reorganization and acquisition stock or a total value of $163,309,900 for the 1,633,099 remaining outstanding shares of reorganization stock and the acquisition stock.

182. Upon audit the Commissioner of Internal Revenue, determining the fair market value for the shares to be less than the plaintiff's valuation, reduced the item of money and property paid in for stock by $83,790,860 or from $321,834,100 as claimed by plaintiff on its excess profits tax return to $238,043,240. Said decrease was determined by the Commissioner to be attributable to the fair market value of plaintiff's preferred and common stock issued incident to the reorganization and to the acquisition of the Oregon Short Line Railroad Company common stock, that is, the reorganization and post-reorganization stock. The decrease was thus a decrease to $79,519,040 from the $163,309,900 at which plaintiff had valued 1,633,099 shares still outstanding reorganization and the post-reorganization stock.

The Commissioner determined that the aggregate fair market value of the reorganization stock was $67,029,150 and that the aggregate fair market value of the post-reorganization stock was $12,489,890.

It does not appear, and it is not material for purposes of comparisons, whether the Commissioner deemed the proper number of shares to be valued 1,633,493 or 1,633,099 and thus whether he valued the number of the reorganization and post-reorganization shares originally issued or as reduced by the cancellation of 394 shares (136 common and 258 prefered).

It will henceforth be assumed for purposes of comparisons that the Commissioner valued 1,633,493 shares. In any event the Commissioner determined the fair market value of stock valued by plaintiff at $163.3 million, to be $79.5 million, or less than 50 percent of plaintiff's valuation.

183. The issue is the valuation of the reorganization and acquisition stock for purposes of computation of plaintiff's excess profits tax credit for 1940 through 1942 based upon invested capital. The standard for determination of value is, as determined in the conclusions of law, the fair market value at the time of the issuance of the stock.

"Fair market value" is henceforth sometimes abbreviated to "value"; "value" when hereinafter used refers to "fair market value," unless a different meaning appears from the context.

184. Solely for purposes of the issue of valuation, it is agreed that the 150 shares of acquisition common issued after June 30, 1901, for Oregon Short Line common stock had a fair market value when issued of $175 per share.

185. The 610,000 shares of reorganization common, the 750,000 shares of reorganization preferred and the 273,493 shares of acquisition common, a total of 1,633,493 shares, are the shares issued for the money and property paid in, and those shares are thus the shares whose valuation determines money and property paid in, without regard to any cancellation of such stock thereafter.

Accordingly, while these findings will address themselves to per share values, the blocks of stock to be considered and aggregated will be the blocks originally issued, without regard to the cancellation of 394 shares after the original issuance.

186. Plaintiff contends that the value of the reorganization and acquisition common was $175–200 per share and the value of the reorganization preferred was par or $100 per share.

These values ($200 for the common and $100 for the preferred), when applied to the total of 1,633,493 originally issued reorganization and acquisition shares give an aggregate total valuation of $251,698,600.

Plaintiff thus now puts a value of $251.7 million on the stock it valued in its return at $163.3 million.

187. The Government has in an additional defense alleged that the Commissioner had only partly eliminated the overstatement in money and property paid in for stock; and that the fair market value of the reorganization stock was $47,450,000 and the value of the acquisition stock was $10,000,000 or less, a total of $57,450,000.

More specifically, on the trial, the Government has contended that the value of the 610,000 shares of reorganization common was $22.50 per share or an aggregate of $13,725,000; that the value of the 750,000 shares of reorganization preferred was $45 per share or an aggregate of $33,750,000; and that the value of the 273,343 shares (all but the last-issued 150) of the 273,493 acquisition shares issued at various times between 1899 and 1901 ranged from $35 to $112 or an aggregate of $10,046,021.50, bringing the aggregate value contended for by the Government to $57,521,021.50.

The Government thus now puts a value of $57,521,021.50 on the stock which the Commissioner of Internal Revenue valued at $79,519,040. The former figure is 72.3 percent of the latter; the latter is 138.2 (more precisely 138.24344) percent of the former.

188. The various valuations are

$251.7 million—plaintiff's valuation contended for on trial
$163.3 million—plaintiff's valuation in its return
$79.5 million—The Commissioner's valuation
$57.5 million—the Government's valuation contended for on trial

189. A comparison of the per share valuations contended for by the Government with the per share valuations derived from the Commissioner's valuation is as follows. The pro forma per share valuations by the Commissioner are obtained by multiplying the Government's per share valuations of the reorganization stock by 141.19 percent, and the Government's per share valuations of the post-reorganization stock by 124.33 percent, these being the percentages by which the Commissioner's aggregate valuations, respectively, exceed the Government's aggregate valuations.

Findings of Fact

Shares	Valuation contended for by the Government		Derived valuations by the Commissioner of Internal Revenue	
	Per share	Aggregate	Per share	Aggregate
Reorganization Stock:				
610,000 common	$22.50	$13,725,000.00	$31.76	$19,373,600.00
750,000 preferred	45.00	33,750,000.00	63.54	47,655,000.00
Total		47,475,000.00		[1] 67,028,600.00
Post-Reorganization Stock:				
137,301 common	35.00	4,805,535.00	43.51	5,974,515.71
68,650 common	35.25	2,419,912.50	43.82	3,008,586.25
27,460 common	35.375	971,397.50	43.98	1,207,718.28
31,642 common	38.00	1,202,396.00	47.24	1,494,894.64
1,966 common	43.75	86,012.50	54.39	106,936.63
3,688 common	72.00	265,536.00	89.51	330,131.32
2,636 common	112.00	295,232.00	139.24	367,052.45
Total		10,046,021.50		[2] 12,489,835.28
Total all stock		57,521,021.50		[3] 79,518,435.00

[1] The actual valuation by the Commissioner of Internal Revenue was $67,029,150.00
[2] The actual valuation by the Commissioner of Internal Revenue was $12,489,890.00
[3] The actual valuation by the Commissioner of Internal Revenue was $79,519,040.00

2. *Issuance of the Stock*

(a) *Issuance of the Reorganization Stock*

190. On October 5, 1893, 31 years after the original Union Pacific was incorporated, three of its stockholders filed a complaint in the Circuit Court of the United States for the District of Nebraska, alleging that the company would fail to meet its expenses and charges in 1893 by at least $3 million and that the company was insolvent, and asking that receivers be appointed for the entire system. On October 13, 1893, the court issued an order appointing receivers as requested in the complaint.

191. On January 21, 1895, the trustees of the Union Pacific first mortgage filed in the same court a bill to foreclose the mortgage. A decree of foreclosure was issued on July 29, 1897.

192. Under date of October 15, 1895, a committee headed by Louis Fitzgerald published a plan for the reorganization of the railroad. It proposed that a new company (or a reorganized Union Pacific Railway Co.) should succeed to main lines and lands covered by the mortgages included in the plan and that the new company should issue to the reorganization committee $100 million in first mortgage 4 percent bonds, 750,000 shares of $100 par value noncumulative preferred stock, and 610,000 shares of $100 per value common stock. A major portion of the new securities were to be distributed by

the reorganization committee to holders of the securities of the plaintiff's predecessor.

193. On January 29, 1897, the United States filed in the court referred to in finding 190, a bill to foreclose a lien existing under certain statutes against the Union Pacific line from Council Bluffs to Ogden. A decree of foreclosure was issued on July 29, 1897.

194. Pursuant to the two decrees of foreclosure, the railroad (except for the lines and lands of the Kansas Pacific and Denver Pacific) was sold on November 1, 1897, to Louis Fitzgerald and Alvin Krech, as purchasing trustees for the reorganization committee.

195. Pursuant to the decree of foreclosure under the suit filed by the United States, the reorganization committee paid, for the assets involved, $40,253,605.49 in cash, as follows:

October 25, 1897	$2, 000, 000. 00
November 1, 1897	4, 100, 000. 00
December 6, 1897	8, 538, 401. 38
December 16, 1897	8, 538, 401. 38
December 27, 1897	4, 000, 000. 00
December 28, 1897	4, 538, 401. 38
January 6, 1898	8, 538, 401. 35
Total	40, 253, 605. 49

196. Pursuant to the decree of foreclosure of the Union Pacific first mortgage, the reorganization committee paid $50,637,435 for the assets involved. Of this amount, $5,373,249 was paid in cash and the balance was apparently paid by use of the first mortgage bonds deposited with the committee.

197. On January 17, 1898, the purchasing trustees assigned their two bids at the sale to the plaintiff. On January 22, 1898, two deeds were executed, conveying to the plaintiff the property sold on November 1, 1897. One of the deeds was executed by the special master, the purchasing trustees and the predecessor and the other (on the foreclosure under the first mortgage)) by the special master, receivers, trustees, the purchasing trustees and the predecessor.

198. Pursuant to the plan of reorganization, plaintiff issued $90 million in first mortgage bonds and the reorganization stock (750,000 shares of preferred stock and 610,000

shares of common stock) to the reorganization committee for money and property acquired by the reorganization committee.

199. On January 31, 1898, in the foreclosure proceeding brought by the United States, the court issued a decree approving and confirming the payment of the purchase price, the assignment of the bid to the plaintiff and the execution and delivery of the deed conveying to the plaintiff the property sold on November 1, 1897.

200. On January 31, 1898, the two deeds of January 22, 1898 and plaintiff's first mortgage were recorded at Omaha in Douglas County, Nebraska.

201. On January 31, 1898, the Mercantile Trust Company, the depositary under the plan of reorganization, advertised that on and after January 31, 1898 it was prepared to issue plaintiff's new securitites (its bonds and preferred stock) in exchange for certain old bonds and the purchase money certificates, and on that day the Mercantile Trust Company in fact issued some of the new securities.

202. At midnight at the end of January 31, 1898, plaintiff took possession of the property sold on November 1, 1897, including the main line from Omaha to Ogden.

203. On February 9, 1898, the Mercantile Trust Company advertised that it was prepared as of that date to issue plaintiff's preferred and common stock in exchange for certificates of deposit of the common stock of The Union Pacific Railway Company.

204. The plan of reorganization provided that it could be abandoned by the committee at any time and included a procedure for making substantial changes in the plan.

205. By reason of the events of January 31, 1898, described in findings 199–202, on that day the plan was no longer contingent and could no longer be abandoned or changed substantially.

206. January 31, 1898 is the date of the issuance of the reorganization stock.

(b) *Issuance of the Post-Reorganization Stock*

207. The dates of the issuance of the acquisition stock are as stated in finding 179.

3. *Cash Assessments on Old Stockholders*

208. Under the plan of reorganization of the Union Pacific Railway Company dated October 15, 1895, the common stock was assessed at the rate of $15 per share. A holder of one share of the old common who paid the $15 assessment was entitled to receive one share of the new common plus 15/100ths of one share of the new preferred. In other words each recipient of 1 new share of common was assessed $15; a total of $9,130,275 was received on account of these assessments.

209. As appears in finding 179, the post-reorganization stock—all common—was issued on the basis of 1 new share (acquisition common) for 1 share of Oregon Short Line common plus $3. In other words, each recipient of one share of post-reorganization common was assessed $3. The sum of $815,820.62 was received on account of these assessments.

210. The foregoing cash assessments of $15 and $3 were part payment for the shares being issued or, put otherwise, the shares being issued were issued in part for property and in part for money, the respective cash assessment. The shares were thus being issued for a combination of money and property and as determined in the conclusions of law the money—the cash assessments—is not to be included in equity invested capital in addition to the fair market value of the stock which was issued.

4. *The Expert Witnesses*

211. The value of the stock was the subject of testimony by an expert witness for each party. The direct testimony of these experts was exchanged before trial and the witnesses began their testimony at the trial with cross-examination. Both witnesses qualified as entitled to testify to their opinions.

(a) *Qualifications of the Plaintiff's Expert*

212. Plaintiff offered the testimony of Mr. Alexander Sachs as its expert witness on the stock valuation issues. Mr. Sachs is an independent economist, investment adviser and busi-

ness consultant. He has not held himself out to the public as an investment adviser and is not registered as such with the SEC.

213. He has testified before this court as a witness for the United States, in a proceeding to determine the value of common stock for purposes of the World War II Excess Profits Tax Act, specifically the value at which such stock should be included in a taxpayer's equity invested capital for purposes of determining its excess profits tax credit. He also has testified before the Federal Communications Commission, the New York Public Service Commission, and the Pennsylvania Public Utilities Commission regarding a fair rate of return.

214. Mr. Sachs was graduated from Columbia University in 1912, and shortly thereafter became an employee of Lee Higginson & Company, an investment firm, working on the effect of the money market on the purchase and issuance of various securities.

In 1915 he undertook studies in jurisprudence and administrative law at Harvard; and in the following year he assisted Mr. Justice Brandeis and Professor Felix Frankfurter in work related to foreign affairs.

215. During the early 1920's Mr. Sachs was employed in studying individual investment situations.

In 1929 he became the chief economist and director of investment research for a diversified investment fund, founded by Lehman Brothers, which ultimately became the Lehman Corporation. As director of investment research for the Lehman Corporation he directed staff members engaged in investment research, and reviewed problems in economics, banking and the economic outlook for particular industries and general economic conditions. He was also a member of the portfolio committee of the Lehman Corporation. He was a director of the Lehman Corporation from 1931 to 1959 and a vice president of that company from 1936 to 1942.

In 1933 he headed the Economic and Planning Division of the National Recovery Administration. In 1956 and 1957 he was a special consultant to the Federal Reserve Board on problems of credit and credit institutions. He has par-

ticipated in various governmental and industrial committees and conferences.

216. Mr. Sachs has also rendered advisory and consultant services on economic and investment problems as well as on industrial management problems to a major oil company, a mid-western insurance company, a New York bank, a prominent French bank and to various investment management firms.

217. He has at various times been a member of various learned societies, including the American Economic and Statistical Association, the Econometric Society, the Society of Security Analysts, the American Political Science Association, the Royal Economic Society, and the Conference of Business Economists. He has lectured at the University of Virginia, Swarthmore, St. John's College and the Academy of Political Science. Mr. Sachs has not published any books or articles on the valuation of securities. He has published numerous articles in professional journals; the titles and subjects of some are: FINANCIAL DYNAMICS OF U.S. RECOVERY, 1937–38; LOGISTICS PETROLEUM PIPELINE SYSTEM FOR WAR PROSECUTION, 1942; RESTORING ECONOMIC-CULTURAL BASES FOREIGN INVESTMENT, 1950; CRITIQUE OF THE CYCLE THEORY, 1953; INFLATION AS SOURCE AND CHALLENGE, 1958; also chapter contributions to AMERICA'S RECOVERY PROGRAM, OXFORD UNIVERSITY PRESS, 1934; and to MORAL PRINCIPLES OF ACTION, Harper's 1952.

(b) *Qualifications of the Government's Expert*

218. The Government offered as its expert witness on the stock valuation issues, Mr. Arthur Jansen, a general partner of W. E. Burnet & Company, a New York City brokerage firm. Mr. Jansen is a specialist in the analysis and valuation of railroad securities.

219. He has testified as an expert witness in four cases before the Interstate Commerce Commission and one case in this court. His appearances before the ICC were on behalf of railroads or railroad stockholders. One of the ICC cases concerned the division of freight rates on transcontinental shipments. He was retained by a group of eastern railroads to present various financial aspects of ten eastern

roads and to make comparisons with seven Mountain Pacific roads. His other testimony before the ICC concerned the fairness of plans of railroad recapitalization or railroad reorganization. His previous appearance in this court was on behalf of the Government with regard to the fair market value at the time of issuance of the preferred stock of a natural gas transmission company, issued in 1929 through 1931 in the construction of a pipeline.

220. Mr. Jansen attended Columbia College and the Columbia School of Business, graduating with a degree of Bachelor of Science in 1927. He has worked for Wall Street firms in investment research since 1930. In 1930 he began research work for a member firm of the New York Stock Exchange. In 1938, he went with his present firm as head of the research department. He became a partner in 1943 and since then has been the partner in charge of research activities.

221. His primary interest has been the railroad industry, an interest dating back to railroad courses he took in college. Since 1937 he has published at least 400 articles in *Barron's*, a widely read financial weekly; in recent years he has contributed four articles a year. About 90 percent of these articles have been on railroads, the remainder having dealt with public utilities and industrials. In the 1940's many of his articles dealt with reorganized railroads, setting values for proposed new securities under varying conditions, and the recovery he foresaw for the bonds of railroads which had been in bankruptcy in the 1930's and the depressed medium-grade bonds of other railroads. For some years he also wrote for his own firm a monthly letter on railroads, devoted mainly to trends in the industry and current developments. For several years in the 1950's he served as editor of the Annual Railroad Survey of "The Investment Dealers Digest."

In connection with his interest in the railroad industry, Jansen has made numerous inspection trips. He has interviewed many railroad executives and carries on extensive correspondence with them. He also attends meetings of the New York Society of Security Analysts on railroad matters and

does extensive reading on current developments in the railroad industry.

222. He taught financial analysis of railroads and railroad securities at the New York University Graduate School of Business from 1943 until 1955 or 1956, corporation finance at Columbia in the 1950's, analysis of industrial securities at the American Institute of Banking, and analysis of industrial and public utility securities at a summer course of the Graduate School of Banking of the American Bankers Association.

He is a long-time member of the New York Society of Security Analysts and was chairman of its Railroad Committee from 1948 through 1950. In 1968 he passed the examination of the Financial Analysts Federation to qualify as a Chartered Financial Analyst.

5. *Valuation Dates*

(a) *Plaintiff's Valuation a Valuation as of 1907*

223. Mr. Alexander Sachs, the plaintiff's expert, testified that

(a) "The 749,742 shares of Union Pacific preferred when issued incident to its reconstitutive-reorganization, had a fair market value, as evaluated by contemporaneously governing money rates, related to a 4 percent yield, of $100 per share."

(b) "The 883,357 shares of Union Pacific common stock [a reference to the reorganization common and to the post-reorganization stock, which was all common] when issued incident to its reconstitutive-reorganization, had a fair market value or investment worth, figured conservatively, in the range of $175 to $200 per share."

224. The witness derived his dollar figures for the preferred from a contemporaneous 4 percent money rate and for the common from price-earnings ratios for eight selected railroads during 1901–1907, multiplied by the total earnings per U.P. share as determined by him. The valuations of both preferred and common, however, were a product of the witness' concept of a "reconstitutive-reorganization" which began in 1893 and ended in 1907.

225. (a) The witness' theory, which he said was held or espoused by no one else, was that only the financial or technical reorganization of Union Pacific took place on January 31, 1898, and that the true reorganization was a "reconstitutive-reorganization," a term apparently coined by him, which ended in 1907, a date vainly sought in plaintiff's post-trial brief to be amended to 1905.

(b) In his prepared direct examination the witness testified, on the subject of the duration and terminal date of the reconstitutive-reorganization, that "the reconstitution was, for all intents and purposes, accomplished at the close of the 1907 fiscal year."

(c) At the trial he testified that "[i]t is a terminal time span, the earliest part of which is the post-Northern securities case and the retirement of the directors of the Union Pacific from the board and the ensuing collaboration between the Northern Pacific and the Union Pacific in the Clearwater district. . . . That date was in 1905, around May, I think, but it extended through the ensuing year . . . through 1906 . . . into the end of the fiscal year 1907."

(d) The testimony of the plaintiff's expert must be taken to be that the "reconstitutive-reorganization" ended in 1907. In part this conclusion is rested on the actual words of the testimony and in part on the substantial reliance by the witness, for his valuation, on earnings of other railroads for the period 1901–1907 as a source of ratios to be applied to earnings per share of the U.P. over the period 1901 through 1907, and on other data with respect to groups of years ending in 1907.

226. The valuations by plaintiff's expert were thus valuations as of 1907, not as of 1898 and not as of 1898 taking into account then foreseeable events. Only if one could in 1898 foresee all events to 1907 could his valuations be described as valuations as of the earlier date taking into account future events so far as then foreseeable.

(b) *Plaintiff's Underlying Theory of a Reconstitutive-Reorganization*

227. The concept of a reconstitutive-reorganization underlies the valuation of plaintiff's witness and his utilization of

1907 as the date as of which he valued the stock. This concept is the subject of the following findings.

228. A valuation of the U.P.'s common and preferred shares, the plaintiff's expert testified, requires that full attention be given the following fundamental and readily apparent facts concerning the construction, receivership, and reconstitutive-reorganization of the U.P., which he felt have for the most part largely been ignored in the great body of literature with respect to the road:

(1) The so-called "effective" date for the "financial reorganization" of the U.P. as of January 31, 1898 cannot be utilized as a proper date of valuation of the reorganized company inasmuch as:

(a) The reorganizers of the U.P. were dealing with a company which had become dismembered during the course of its receivership, and did not consider their task of reorganization to have been completed until that point in time when Union Pacific was fully reconstituted into a functioning railroad system. Thus the reorganizers of the U.P. would never have undertaken its reorganization, which involved the expenditures of great sums of money, unless they had been and were assured, among other things, that during the course of, and as a part of, that reorganization the Oregon Short Line and Oregon Railroad & Navigation Company, the U.P.'s gateway to the Northwest, would be reintegrated into the U.P. system;

(b) The pre-receivership competitive challenges thrown up to the Union Pacific Railway by the Chicago, Burlington & Quincy Railroad, which continued to persist throughout the U.P.'s receivership, and culminated in the Hill-Morgan combination of the Northern Pacific and the Great Northern Railroads, constituted a threat to the U.P.'s very survival, a fact which was well known to the reorganizers of that company who in the course of such reorganization were required to, and did, deal with such threat as an integral part thereof;

(c) The threat of the transfer of majority control of the Southern Pacific to a competitor of the U.P. had to be effectively overcome by the reorganizers of the U.P. and until

such threat had been met no true and concise determination of the value of the reorganized company could be made;

(2) The receivership of the U.P. and its various branch and auxiliary lines was not inevitable, but rather was undertaken as a means of solving problems inherent in the original charter of the U.P., which were occasioned by the high cost of the road's construction during the inflationary Civil War years, and which arose from the oppressive burden of the U.P.'s indebtedness to the Federal Government; and

(3) The fact that there was, just prior to U.P.'s receivership, and continuing throughout its ensuing reconstitution, a shift in the ownership of its equity from domestic to foreign holders, who were predominantly British.

229. Plaintiff's expert further testified that the U.P.'s reconstitutive-reorganization was to be distinguished from its financial reorganization, as follows:

(a) The U.P.'s reorganization was singular and distinct from those of other railroad reorganizations which were effectuated during the last decade of the 19th century and the first decade of the 20th century. The preponderance of other railroads reorganized during the aforementioned period remained intact as physical transportation systems during their respective receiverships. Their receiverships were brought about due to an inability to meet creditor obligations. In turn such receiverships were in each case replaced by "financial reorganizations" which were directed towards, and in fact accomplished, a rearrangement of such companies' financial structure in order to meet their creditors' demands.

(b) On the other hand, the reorganization of the Union Pacific was to be contrasted with the said "financial reorganizations," undergone by various railroads. The U.P. did not during its receivership undergo a mere readjustment of its capital structure to meet creditor demands. Rather it was subjected to an extensive dismemberment and disintegration, and therefore the effective date of its "financial reorganization," as of early 1898, applied to only a very small portion of the transportation system which in fact was reorganized. From the standpoint of economic functioning, that small fraction of road, which underwent a "financial reorganiza-

tion" in early 1898, was in no way related to, nor could it be equated with, the great system which existed during the U.P.'s pre-receivership years. That integrated system, the true economic entity, was reestablished later through its reconstitutive-reorganization. It was to this great system and not to its component parts that an investor would look. The small fraction of road which resulted from the early 1898 "financial reorganization" was in a state of vulnerability to accentuated competition from neighboring transportation systems, and thus could not have been, nor was it, the economic entity which was the goal of the reorganizers of the U.P. Accordingly, it is to be concluded that as of the date of its "financial reorganization," the U.P. had in fact only begun to embark on its true reorganization, its "financial reorganization" being merely the overture and prelude to the economic reconstitution and real reorganization of its requisite prior parts, and the rehabilitation of its competetive functioning in the post-receivership period. That competition was not only for local and trunk line traffic, but also for transcontinental traffic with competing systems, which systems for the most part had gone through their own individual receivership structurally intact, without the fractionation peculiar to the U.P. Thus while its competitors were reorganized as a unit, the foreclosure of the liens of the Union Pacific branch and auxiliary lines required a multi-step reorganization before the economic unit could in fact be reorganized.

(c) Accordingly, it is to be concluded that the reorganization of Union Pacific was not completed until that point in time when the system had been reconstituted, and the competitive threats which had existed prior to, and during receivership, had been effectively dealt with. The earliest possible point in time at which the reorganization of the U.P. could be considered completed was the latter part of 1905, when friendly relations were restored between the U.P. and the Northern Pacific, continuing to the end of the fiscal year 1907. See also finding 225.

230. It is found that the witness testified that the reorganization was completed at the end of the fiscal year 1907.

231. Plaintiff's expert further testified that

Findings of Fact

(1) The reorganization of the U.P. necessarily encompassed the reintegration of the Oregon's lines into the U.P.'s system, as follows:

(a) It is to be repeatedly emphasized that the reorganizers of the U.P. from the outset worked to bring about a reconstitution of the system as it existed in the pre-receivership time, i.e., to bring back into the system on a satisfactory basis all of its important branch and auxiliary lines which had been cut off during the receivership, and thereby restore to the U.P. its connection with the Pacific Ocean.

The U.P.'s receivership brought about the complete dismemberment of the system, and its reorganizers had, from the outset, no less a goal than the reintegration into the system of the Oregon Short Line Railroad, the Oregon Railroad and Navigation Company, the Omaha and Republican Valley Railroad, the Union Pacific Lincoln & Colorado Railroad, the Kearney & Black Hills Railroad, the Junction City & Fort Kearney Railroad, the Julesburg Branch of the Union Pacific, Denver & Gulf Railroad, the Carbon Cut-off Railway, the Echo & Park City Railway, the Solomon Railroad, and the Salina & Southwestern Railway.

An important factor leading to the conclusion that the reorganization contemplated reacquisition of the various aforesaid lines of road, was that the prereceivership U.P. controlled or owned some 7,681.72 miles of railroad, of which it had lost during receivership some 5,832.43 miles, which included its connection with the Pacific Ocean, and therefore, as of the date of its "financial reorganization," consisted of only 1,849.29 miles of railroad.

Another important factor of great weight was the manner in which the reorganizers of the road reintegrated the various branch and auxiliary lines, as well as the speed with which such reintegration was accomplished. The 1891 Collateral Note Trust Indenture, to which had been pledged, as security, all of the stocks and bonds of Union Pacific Railway's auxiliary and branch lines, played a large part in the plans of the reorganizers. More specifically, as early as 1895 the reorganizers of the Union Pacific commenced purchasing from the trustee of the 1891 Trust much of the aforesaid collateral, acquiring such securities in the name of the reorgani-

zation committee for the account of the new company. All of the various acquisitions made by the reorganization committee from the trustee under the 1891 Indenture were made for the account of the Union Pacific Railroad, the purpose behind such acquisitions being to reintegrate into the U.P. those profitable branch and auxiliary lines which had been lost during receivership.

(b) The U.P.'s reorganization from the outset looked to the reacquisition of the Oregon lines. In the final settlement worked out between the reorganization committee and the Federal Government with respect to the Government debt, the reorganizers planned to secure for the benefit of the U.P. the various securities of the Oregon lines which were held as collateral in the Morgan-Drexel Trust of 1891.

The reorganization committee from the outset looked to reacquisition of the Oregon lines as part of their reorganization scheme. A failure to carry forward the reorganization plans would have adversely affected many other large affairs and interests in which the reorganizers were involved; particularly the comprehensive plans which had been made by them to recover the lines lost to the old Union Pacific system, plans which included an agreement to purchase the Oregon Short Line stocks, held by the firm of J. P. Morgan under an old trust indenture of 1891. In the fall of 1897 the reorganization committee "had gone too far to be able to retrace its steps." Accordingly, the reorganizers of the road acceded to the demands of the Federal Government, paying in full Union Pacific's indebtedness both for principal and interest.

(c) In about December of 1898 the U.P. announced that it was to absorb the Oregon Short Line through an exchange of its common stock. The act of acquisition of the Oregon lines was not to be regarded as a new development nor as introducing into the reorganization a new factor. It was only the method of carrying out the acquisition which constituted a new feature. The fact that a large block of Short Line stock had been purchased in 1897 by the reorganization committee from the Morgan Trust and was held in the interests of the Union Pacific has been well established for a long time. The investment public had long been aware of the fact that

the reorganization of Union Pacific necessarily carried with it a reacquisition and reintegration of the Oregon lines.

232. The plaintiff's expert further testified that the reorganization of the U.P. necessarily encompassed the reorganizers' plans for dealing with pre-receivership challenges to its transcontinental role as follows:

(a) Another major factor, as noted above, in determining the point in time at which the U.P.'s reorganization was completed, was the manner in which its reorganizers dealt with threats to the U.P.'s transcontinental position by competing roads. The first of these threats was the possibility that major control of the Southern Pacific would fall into the hands of a competitor. The second of these threats took the form of the pre-receivership challenges of the Chicago, Burlington & Quincy Railroad, which continued to persist throughout Union Pacific's receivership, and culminated in a settlement between the U.P. and the Hill-Morgan combination. Had not both of these problems been overcome during the course of reorganization, the U.P. would have been reduced to the position of a trunk line without feeders of its own, dependent for freight upon traffic arrangements which it might make with rival systems.

The various groups of security holders within the U.P. system struggled to put themselves in position to form alliances with other systems should the U.P. be broken up. It would be utterly false and erroneous to attempt to evaluate the U.P. as of the date when it emerged from its so-called "financial" reorganization, inasmuch as at that point in time it merely constituted a truncated fragment, nowhere resembling its pre-receivership identity or the entity which its reorganizers, officers and faithful investors envisioned from the outset as the system which would emerge from the true reorganization.

(b) The Southern Pacific and the Central Pacific were important to the U.P. The U.P. in early 1901, put the keystone to its arch through the purchase of control of Southern Pacific, thus permanently assuring to it possession of the Central Pacific connection. By 1901 the U.P. had determined on the purchase of Central Pacific or, in the alternative, the construction of a new line from Ogden to San Fran-

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Findings of Fact

cisco. The acquisition by Union Pacific of Southern Pacific was to protect the System from further threats of truncation.

The opportunity afforded the U.P. to acquire a controlling interest in Southern Pacific must be considered to have been a defensive move on its part to protect the System which was then in the final stages of its reconstitutive-reorganization.

The acquisition of Southern Pacific was to protect and maintain the position of the System, safeguard its future against combinations of other lines, which, should they become hostile, might divert its business by changes in the existing channels of transportation.

(c) With respect to the Chicago, Burlington & Quincy threats, problems arose in the late 1880's between the U.P.'s management and the management of the Burlington. During the period of time wherein the U.P. was attempting to extricate itself from the problems of the Government debt, great obstacles were thrown in its way by the Burlington. The campaign which was waged by the Burlington was calculated to bring about the insolvency of Union Pacific and destroy its transcontinental character.

The challenges thus presented to the U.P. by the Burlington carried over into 1901. This is evident in the fact that the tenure in office of President Perkins of the Burlington did not terminate until 1901. Coupling this fact with the fact that it was during the closing years of Perkins' presidency of the Burlington that the negotiations which culminated in the Hill-Morgan combination took place, leads to the conclusion that there was a connection between the two incidents which was evident to the reorganizers of the U.P.

The acquisition by the U.P. of the preferred stock of Northern Pacific was a protective measure, undertaken to preclude the reduction of the U.P. to a trunk line without feeders. The purchase of a majority interest in the Burlington by the Great Northern and Northern Pacific was an invasion of U.P.'s territory.

The ultimate resolution of the problems created in the Hill-Morgan combination were not effectively dealt with until that point in time at which a settlement between the parties was effected. This did not occur until the Supreme Court ruled on the proper distribution to be made by the

Northern Securities Company of the stock and securities of Northern Pacific which it had acquired during the early 1900's.

In the light of the foregoing, it is to be concluded that reconstitution of the U.P. could not be considered complete until the dangers and threats to its transcontinental position had been surmounted. The earliest point in time at which the Burlington threat, as personified in the Hill-Morgan combination, could possibly have been settled was in 1905, when the U.P. and Northern Pacific joined in the construction of some 500 miles of road in the Clearwater District of Idaho, and the time extended to the end of fiscal 1907.

233. The plaintiff's expert further testified that

The Union Pacific's receivership was not inevitable but was undertaken to solve problems inherent in the original charter, as follows:

(a) An understanding of the true reorganization of the U.P. requires a thorough knowledge of the causes which underlay its receivership and its dismemberment during receivership; that not until these factors are firmly understood can a true appreciation of the actual goals of the organizers of the road be possible and not until these goals are appreciated can the reconstitutive-reorganization be understood.

(b) One principal cause of the receivership and subsequent dismemberment of the U.P. was inherent in the original charter of the Pacific Railroads, which denied to the road the legal power to effectuate any meaningful unification of its branch and auxiliary lines. Thus the road lacked the economic flexibility necessary to utilize such unification as a basis for refunding the existing debt obligations at interest rates lower than those with which the road was burdened at the time of original construction. Because of this restriction, the road was denied substantial financial advantages which other competing systems had available.

(c) The earnings power limitations which arose from the U.P.'s charter restrictions were not only known, but were of vital concern to both management and the long term equity investor over the pre-receivership period.

(d) The restrictions and their interrelationship with the problems of the Government debt ultimately led to the U.P.'s

receivership. The receivership of the U.P. in 1893 was effectuated more to force a settlement with the Government than from actual necessity.

(e) Other transcontinental systems entered into the field of U.P. competitors. The financial impasse faced by the U.P. prevented unification with its subsidiary companies, and also prevented a refunding of its fixed charges and indebtedness due to the interdictions placed upon changes in its capital construction. The Thurman Act of 1878 required the U.P. to pay over to the Federal Government all of the transportation revenues derived on account of services rendered to the Government, for investment in the sinking fund and for annual payments to be applied on the Government debt.

(f) The charter restrictions are to be related to the extremely high costs incurred in financing the original construction of the U.P., as compared to the lower costs of construction which its competitors were able to take advantage of during the 1880's.

An additional factor underlying the U.P.'s receivership was the advantage available to other railroads, direct competitors of Union Pacific in many instances, to obtain financing at the much lower interest rates which prevailed during the 1880's. The Northern Pacific and Manitoba was built in 1887, and thus enjoyed the advantage of low construction costs, while the U.P. was financed during the post-Civil War inflation at a time when labor and capital were scarce and costs high.

(g) Had the U.P. been free of the constraints inherent in its original charter, it would have been able to refund the excessively high fixed charges which it bore as the result of wartime finance and, therefore, could have guaranteed, without the necessity of refunding through the collateral trust medium, the prior burdens which had been incurred by its branch or auxiliary lines. Furthermore, after other transcontinental systems entered into the field of U.P. competitors, U.P.'s defensive construction, undertaken to counter the competing transcontinentals, could have been accomplished at lower costs, and would not have resulted in excessive rate reductions. Each of the foregoing factors (inability to refund

excessively high fixed charges; necessity of utilization of collateral trust financing; high cost of defensive construction; and excessive rate reduction) were causes of U.P.'s receivership and dismemberment, and the reorganizers of the road during the course of their reorganization had effectively to deal with these factors so that they would never again work to the detriment of the System.

234. The plaintiff's expert further testified that

(a) A second cause of the road's receivership and subsequent dismemberment was the problems arising from the Government debt and the means which had to be utilized in order to meet that indebtedness.

Tracing the U.P.'s obligation to the Federal Government from inception up to and including its ultimate payment in full of that obligation and, for the aforesaid conclusion, using in great part the U.P. annual reports to stockholders for the period which immediately preceded its receivership, it was noted that President Charles Francis Adams, as early as 1887, had adopted a program designed to accelerate a solution to Union Pacific's political and economic problems. Further noted was Adam's reference to the so-called Outhwaite Bill, which was then pending before the Congress, and which would have provided for a refunding of the Government indebtedness for some 50 years at a lower rate of interest. Highly significant was the Adams statement to the effect that the passage of this legislation was prevented only by a small body of opponents, and though it had not yet been enacted into law, represented the views of the United States Government in all of its departments, and the further Adams statement that the company hoped soon to resume payment of dividends.

(b) The defeat of the aforesaid legislative proposal resulted from political, rather than economic reasoning. In support of this conclusion is the fact that during the late 1880's and early 1890's the country experienced a strong Populist Movement whose principal champion was William Jennings Bryan. The convergence of this movement on the political scene, at a time when the U.P. was attempting to extricate itself from problems which arose in the early years of its construction, prevented a final solution from being effec-

tively reached, and necessitated receivership, dismemberment and the reconstitutive-reorganization of the System.

(c) The foregoing conclusions were borne out by the final settlement effectuated with the Government, as well as the immediate prosperity realized by the U.P. System within a short period of time thereafter. The settlement with the Government was not less than brilliant. Referring to the sequence of events which transpired in 1897, and which led up to the final payment in full to the Federal Government of U.P.'s indebtedness in the fall of that year, and particularly events as they concerned the last minute postponement of the Government's foreclosure sale, it was evident that, should further delay have been encountered, serious consequences would have ensued and Union Pacific would not have been able to effectuate its reconstitution. Only through the alliance of the foreign-based bankers, who underwrote the reorganization, and men such as E. H. Harriman was the settlement with the Federal Government accomplished.

(d) In final corroboration of the theory that the Union Pacific's indebtedness to the Federal Government was a major cause which gave rise to its receivership, subsequent dismemberment, and reconstitutive-reorganization, reference was made to the editorial comment which appeared in the *Chronicle* of December 30, 1899, and which dealt in great detail with the U.P.'s annual report for the year ending June 30, 1899, with particular emphasis to the following:

> It is therefore gratifying to find that the offsetting advantages of the new arrangement, whereby the road is no longer hampered by Government interference and the managers are free to carry out whatever policy seems for the best interests of the company, are such as to remove occasion for misgivings in the particular mentioned period.
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> That the property had a future under a capable and efficient administration, at liberty to pursue its own plans, has never been questioned by anyone competent to express an opinion on the point. Indeed it was obvious that the road had certain distinct advantages over other transcontinental lines.
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> * * * * *

One real danger threatened the property when it became involved in the financial difficulties from which it seemed so hard to extricate it. The danger was that the system would be completely disintegrated, impairing the earning capacity of the main line.

* * * * *

But under the energetic and far-sighted management of those who formulated and conducted the reorganization, and who are guiding the new company's affairs, this difficulty has been avoided. All the most desirable lines, branches and feeders have been secured, and are now being more firmly cemented to the system than before.

(c) *The Valuation Dates Utilized by the Government's Expert*

235. The Government's expert utilized the following valuation dates in his valuations (see findings 206–207):

Reorganization Stock	Valuation Date
610,000 common	January 31, 1898
750,000 preferred	January 31, 1898
Post-reorganization Stock	**Valuation Date**
137,301 common	Jan. 26–Feb. 25, 1899
68,650 common	Feb. 26–Mar. 4, 1899
27,460 common	Mar. 5–Mar. 11, 1899
31,642 common	Mar. 12–June 30, 1899
1,966 common	July 1–Dec. 1, 1899
3,688 common	Dec. 2, 1899–June 30, 1900
2,636 common	July 1, 1900–June 30, 1901

(d) *Conclusions as to Valuation Dates*

236. The date of February 2, 1898, the date of the first trading of the reorganization preferred is, as determined in the opinion, the correct date for determining the fair market value of the reorganization stock.

237. The dates of the issuance of the post-reorganization stock between 1899 and 1901, set out in finding 235, are the correct dates for the determination of the fair market value of the respective blocks of post-reorganization stock.

238. The concept of a reconstitutive-reorganization, the basis for the valuations by plaintiff's expert, has no merit whatsoever as affecting the dates of issuance of the stock involved, the correct dates for the valuation of the stock, the

entity with respect to which the stock is to be valued, or otherwise, in any way material to this case.

239. The use by plaintiff's expert of a valuation date of 1907 was the use of an incorrect valuation date, with the consequence that his valuation has no material bearing on the determination of the fair market value of the reorganization stock and the post-reorganization stock at the correct dates for valuation.

His valuation has therefore not been considered on its merits at all, either for its correctness as a valuation for 1907, for 1898 or otherwise.

240. The Government's expert did not use correct valuation dates. See finding 236.

6. *The Dollar Valuation of the Reorganization Stock by the Government's Expert*

241. As already indicated, defendant's expert valued the 610,000 shares of reorganization common at $22.50 per share and the 750,000 shares of reorganization preferred at $45.00 per share.

7. *Pre-Receivership History*

(a) *1869—Construction and Capitalization*

242. The Act of July 1, 1862, the first Pacific Railway Act (c.120, 12 Stat. 489), provided for the construction of a transcontinental railroad from the Missouri River to the Pacific Ocean. Plaintiff's original predecessor, The Union Pacific Railroad Company, incorporated by the Act, was to construct the road westward from the Missouri River to the western boundary of the Nevada Territory, where it was to meet and connect with the railroad to be constructed by the Central Pacific Railroad Company of California. The Government would finance part of the cost of construction by issuing to the Union Pacific 6 percent bonds of the United States payable in 30 years, at specified amounts per mile of road constructed. In addition, the Government agreed to transfer to the U.P. land for the right of way plus five additional sections per mile on each side of the track. In turn, the U.P. agreed to pay the bonds at maturity and to reimburse the Government for the interest. To secure the repayment to

the Government of the amount of the bonds and the interest thereon paid by the Government, the Government was given a first mortgage on all the property of the U.P. In addition, all compensation for services rendered to the Government and at least 5 percent of the net earnings of the road were to be applied to payment of the bonds and interest thereon.

243. These provisions failed to induce sufficient interest in the proposed construction and the road was unable to raise private capital. Not until Congress amended the law in 1864 (Act of July 2, 1864, c.216, 13 Stat. 356), subordinating the Government to a second lien position and granting substantially increased benefits to the road, did it become feasible to go ahead with the project. Specifically, under the amendatory act the land grant was doubled, the number of alternate sections on each side of the line granted per mile was increased from five to ten and the limits within which these sections were to be granted were increased from a distance of ten miles from the line to twenty miles. In addition, the road was authorized to issue its own first mortgage bonds in an amount not to exceed the Government bonds. Also, only half, instead of as formerly the whole, of the compensation for services to the Government was now required to be devoted to payment of the Government bonds and interest.

A still further amendment, on July 3, 1866 (c. 159, 14 Stat. 79) transformed the construction of the Pacific Railroad into a race between the U.P. and the Central Pacific, each to build in a continuous line until they should meet and connect. Land grants were the prize.

244. In 1866 the Union Pacific began construction westward from Omaha, Nebraska, while the Central Pacific built eastward from Sacramento, California. The historic meeting of the two took place in 1869 at Promontory, Utah Territory, 54 miles west of Ogden. The two roads subsequently agreed upon a point five miles west of Ogden as the connecting point from the standpoint of traffic interchange, the Union Pacific selling to the Central Pacific its line west of the agreed point. On this, the Union Pacific had about 1,038 miles of road.

245. The cost of construction to the Union Pacific was very high due to high prices prevailing during the construction period, the speed of construction, and the method of financing

employed. As was common practice, the U.P. used a construction company. The owners of the company, Credit Mobilier of America, were the directors and stockholders of the road itself, as was again common practice. In consequence there was a built-in incentive on the part of the road to maximize the payments for construction and thus the profit accruing to the Credit Mobilier at the expense of the U.P.

The Credit Mobilier received, for the road, the maximum amount of bonds provided by the Government and an equal amount of the U.P.'s first mortgage bonds, along with substantially all of the road's common stock. The sale of these bonds essentially provided the funds for the actual cost of construction, while virtually the entire common stock of the railroad was distributed to the stockholders of the Credit Mobilier. The construction cost stated in the U.P.'s 1870 balance sheet, immediately after the completion of the road, was $97.3 million, while the actual cost of construction to the Credit Mobilier was only about $54.2 million. The profit to the Credit Mobilier was $23.4 million in terms of the market value of securities and cash.

For the $36.8 million in par value of stock issued by the road, it received in cash only $400,650, the balance of the stock constituting a bonus of profit to the Credit Mobilier. As a result, there was no true equity for the common stock, in today's sense of that term.

246. The road had net earnings of $58,357,133 during the period 1870–1879, some of it resulting from charging to construction items chargeable to operating expenses. Interest charges for the same period were $49,438,109, including the interest on the Government debt. Since the latter was not payable until maturity, there was income available for dividends, and dividends in the amount of $11,942,125 were paid from 1875 to 1880.

As time went on, the practice of not providing from earnings for the interest to be due to the Government in the future contributed to the inability to provide for the maturing debt, which by the time of the reorganization amounted to $58,448,223.25 for principal and interest, and was paid in full, on September 30, 1898, as part of the reorganization plan.

(b) *Expansion: Mergers*

247. In 1880 the U.P. was consolidated with the Kansas Pacific, from Kansas City to Denver, Colorado, and the much smaller Denver Pacific, from Denver to Cheyenne, Wyoming, at the U.P.'s main line. The two new railroads added 750 miles to the U.P.'s 1,038 miles.

248. Stock was added to stock and bonds to bonds, the consolidation increasing U.P.'s stock by $14 million, from $36.7 to $50.7 million, its bonds $38.4 million, from $88.4 to $126.8 million, and its miscellaneous debt $5.7 million from $4 to $9.7 million.

249. A large part of the new securities issued went to Jay Gould, in exchange for stock he had acquired. The U.P. was forced to pay hold-up values to Gould, who had managed the consolidation while he was a director of the U.P. According to the report of the United States Pacific Railway Commission (in evidence; see finding 266), pp. 54–65, Gould brought the consolidation about by threats and other methods which, apart from their propriety at the time, would today be regarded as extremely improper. Some of Gould's stock he had acquired at low prices. In other transactions, in the course of his threatened plan to build a competitor of the U.P., he had acquired branch lines at extraordinarily high prices, much greater than value. These lines he was now able to transfer to the consolidated U.P. at the inflated prices he had paid.

250. The Kansas Pacific was a bond-aided railroad, but the aid had been given only to the 100th parallel, a distance of 394 miles. Some $6.3 million in Government bonds were issued, and sold for almost full face value. Upon completion of the road, the Kansas Pacific had issued $32,088,950 of securities, of which $9,437,950 was represented by stock and $22,651,000 by bonds bearing interest at 6, 7 and 8 percent.

251. Records are not available to show the true cost of the Kansas Pacific, but, on the basis of the Union Pacific's experience of construction costs somewhat smaller than the actual issuance of bonds, a reasonable estimate of the actual cost of construction is approximately $22.6 million, the par value of the bonds issued, or about $32,000 per mile. Subsequently the Kansas Pacific issued funding mortgage bonds

to take care of unpaid coupons on defaulted issues, thereby increasing its bonded debt by $1,500,000. At the time of consolidation, the Kansas Pacific had an accumulated deficit of $6,525,069 after fixed charges. Interest on the Government debt, as in the case of the U.P., not payable until maturity, amounted to $4,805,703.

252. The Kansas Pacific had just then emerged from its chronic insolvency (in substantial part due to the reduction in its rates in the course of its fierce competition with the U.P.), and an intelligent and skillful reorganization of its affairs and a recent large improvement in its business had enhanced largely the value of its securities. Nevertheless, there was little to justify the conclusion that its earning power was such as to expect that it could pay a dividend, except, perhaps, that its new relationship with the U.P. might mean a cut in its losses.

Its outstanding bonds were worth considerably below par value and its common stock was of little intrinsic value.

253. The capital of the Denver Pacific consisted of $2.5 million in bonds and $4 million in stock. Records from which construction costs might be learned, the United States Pacific Railway Commission reported in 1887, were missing or unintelligibly kept, and the Commission could not determine the cost of construction other than to note that the construction account was the $6.5 million capitalization. The minority commissioner of the United States Pacific Railway Commission estimated construction cost at $2.5 million. In the light of the practice of the period of using construction companies owned by the stockholders of the railroad company and the practice of issuing stock as a bonus, a reasonable estimate of construction cost is $5 million. The road had had poor earnings and at the time of the consolidation it had a deficit of half a million dollars.

The stock of the Denver Pacific had therefore little or no intrinsic value, other than the road's value as a connecting link between the Kansas Pacific at Denver and the Union Pacific at Cheyenne.

254. By such standards as asset value and earning power, therefore, the consolidation was unfavorable to the U.P. The three roads had much water in their statements and in terms

of capital structure the consolidation led to still further inflation of the capital of the predecessor of the present plaintiff.

There is, however, another point of view. The Kansas Pacific and the Denver Pacific had been the main source of the U.P.'s competition prior to the merger. The fierce competition had almost ruined the Kansas Pacific and severely damaged the U.P. The consolidation had the significant benefit to the U.P. of an end to the competitive wars and an enlargement of its system, both all but indispensable in that era for the U.P.'s survival.

(c) *Expansion: Construction*

255. Between the consolidations of 1880 and the receivership in 1893, the U.P. embarked upon a period of extensive construction. The construction was undertaken through subsidiary companies because the road itself was unable to build additional mileage under the Pacific Railway Acts, specifically the prohibition contained in section 4 of the Act of March 3, 1873 (c. 226, 17 Stat. 509) to the effect that (with minor exceptions here inapplicable) no new stock could be issued nor debt incurred with respect to the property or future earnings of any of the Pacific railroads, without leave of Congress.

256. To initiate the program of construction of branch lines, the U.P. sold an additional issue of $10 million of stock in 1880 and 1881 at par value.

257. Jay Gould, then a director of the U.P., was much involved in the construction of these branch lines. According to the minority report of the Pacific Railway Commission, Gould is estimated to have acquired a fortune of around $40 million, much of it through his dealings in and with the U.P. Some $10 million of this sum were said to have been realized from construction activities in the period immediately following the consolidation of 1880.

Mr. Gould's connection with the road ceased in 1883. The new management was honest, intelligent and energetic. Thereafter construction was economical.

258. Under new management, an even more ambitious acquisition and construction program took place, from 1883

to receivership in 1893. New lines were built with economy and without personal impropriety of the directors, albeit with watered stock. For instance, in the most ambitious project of all, the construction of the Oregon Short Line, book capitalization was $29 million but the cost of construction by third parties, under contract, was "less than $15 million." Bonds were issued to finance the construction, and sold at face value. For every $1,000 bond sold at par, the subscriber received without cost $500 in stock. Half the stock issued was so disposed of and the other half was issued to the U.P. without consideration, which retained it to secure control. There was thus a great deal of water in the capitalization, though more was doubtless realized on the bonds than might otherwise have been obtained.

259. The greatest difficulty caused by the 1880–1893 construction and acquisition program, which was no bonanza for earnings at the time, was the burdensome capitalization and a large floating debt to service the capitalization, which was a contributing factor to the insolvency in 1893. The program was, however, more or less forced on the road from the growing competition east of Ogden, and but for the extension of the System from Ogden, the parent road might have encountered financial difficulties because of competition. The program thus staved off trouble earlier than 1893. And by building a wider system, the program no doubt contributed to the long-range (post-receivership) profitability of the U.P.

(d) *Growth of Competition*

260. Prior to the consolidation of 1880, the U.P. had competition mainly from the Kansas Pacific and its affiliate, Denver Pacific. The sharp rivalry resulted in depressed rates and was to a considerable extent responsible for the chronic financial difficulties of the Kansas Pacific. As a result of the consolidation, the competitive situation was corrected and rates were restored to satisfactory levels.

261. In the years immediately after 1880, however, nine railroad companies entered the territory east of Ogden and four additional lines were built across the continent. In the 1870's and 1880's, the controlling interests in the Central Pacific, which connected with the Union Pacific at Ogden,

constructed a competitive route from San Francisco to New Orleans, reached in 1883, with connections by water to New York. As a result some traffic was diverted from the northerly, Central Pacific-Union Pacific route to the southern route, thereby in effect breaking the monopoly the U.P. had on transcontinental traffic up to that time.

262. Completion of the construction of the Denver and Rio Grande in the 1880's ushered in further competition between Denver and Ogden. Extension of the Chicago, Burlington and Quincy from Kansas City, St. Joseph and Omaha westward to Denver during the same period also brought this line into the U.P.'s territory. Additional construction by the Burlington northward to connections with the Northern Pacific further sharpened competition. In the same era, the Rock Island Railroad added very greatly to its mileage by building lines from Omaha and Kansas City to Denver. In addition, the Atchison, Topeka and Santa Fe Railroad Company constructed or otherwise acquired about 6,500 miles of road, including some mileage in U.P.'s territory, and more particularly it became a transcontinental competitor when it reached the Pacific Coast in 1885. The Northern Pacific and Great Northern also joined the group of transcontinental carriers, the former being completed in 1883 and the latter in 1893.

263. The tremendous increase in competition led to rate-cutting which impaired the earning power of the U.P. Rebates were given to favored shippers and discrimination in favor of certain shippers and communities was commonplace. In order to improve their lot, the railroads, including the U.P., entered into pool agreements with other roads to shore up rates and share revenues. These practices were engaged in by all the roads as necessary for their economic life, and were not necessarily corrupt or improper.

264. The U.P. was not merely subjected to a great deal of competition; it created a great deal itself. Its construction of the Oregon Short Line and the latter's leasing of the Oregon Railroad and Navigation Company were planned to give it a route to the West Coast so as to minimize the use of the Central Pacific. With the empire being built by the Central Pacific and the Southern Pacific from Portland,

Oregon, to New Orleans, Louisiana, the U.P. undoubtedly was put in the position that, in order to survive, it had little alternative but to continue building branch mileage.

(e) *The United States Pacific Railway Commission*

265. Recognizing the imminence of the maturity of the debt owed the United States, Congress in 1887 established the United States Pacific Railway Commission, and authorized it to investigate the books, accounts and methods of railroads which had received aid from the United States and to determine, among other things, whether it would be to the best interest of the Government to extend the maturity of the debts owing to the United States. c. 345, 24 Stat. 488.

266. On December 1, 1887, the Commission, whose members were appointed by the President, delivered its report. A majority report was made by Commissioners E. Ellery Anderson and David T. Littler and a minority report by Commissioner Robert E. Pattison. The report is in evidence as plaintiff's exhibit 413 and is cited herein by name.

267. In addition to its original excessive funded debt and burdensome fixed charges, the road had by 1884 incurred an additional $10 million in floating debt in the mileage expansion beginning in 1880. Moreover, in the period leading up to 1884, earnings were in a declining trend; dividends were omitted in 1884, and were not resumed in the remainder of the time of the receivership in 1893.

268. Beginning in the spring of 1884, the new management of the road devoted itself, by economy and application of earnings to the reduction of the debt and the betterment of the System, in an endeavor to put the road on a sound financial foundation. The new management was successful in eliminating the floating debt, but the basic problems of the road's original capitalization remained.

269. The Pacific Railway Commission approved highly of the U.P.'s new management. The U.P., the Commission reported, "has been entirely extricated from the difficulties which surrounded it at the close of 1883, and stands today as a solvent corporation, in excellent physical condition as to all of its construction, well equipped, and promising ex-

cellent results in the future." There is no reason to doubt this judgment.

(f) *Economic Conditions—1869 to the Panic of 1893*

270. During the first four years following completion of the U.P. in 1869, the nation experienced reasonably good business and the territory served by the road probably enjoyed above-average conditions. The very existence of the U.P. brought growth with it as population flowed in from the East and immigrants began coming to the United States in increasingly larger numbers. At the same time, prices of such farm products as wheat and corn, important crops in the territory served, were maintained at good levels, even though they were far below the abnormally high points attained during the Civil War. Beginning with the Panic of 1873 and extending through 1879, the country went through the long depression of the 1870's. Wheat and corn prices declined moderately from 1875 to 1880, according to United States Department of Agriculture statistics, but the extensive opening of the West left the U.P.'s territory relatively untouched by the depression and the road's revenues continued to grow.

271. In the 1880's wheat and corn prices averaged somewhat lower again, but bountiful crops created generally good conditions. As the decade was coming to a close, however, drought and insect plagues in the United States, recovery in European agriculture, and the development of new growing areas, especially for wheat, in such countries as Canada, Australia, and the Argentine, brought about agricultural depression in the United States. Wheat fell from 95 to 53 cents (prices given here are yearly averages) per bushel from 1880 to 1893; corn fluctuated in the 1880's and finally dropped from 50 to 36 cents per bushel from 1890 to 1893.

272. The steady erosion of farm prices between 1890 and 1893 and the concomitant reduction in demand for the products of industry precipitated the Panic of 1893. Purchasing power of workers declined along with the fall in farm prices, and in the short period 1890–1893, wages received were decreased over one-third. Thus was ushered in a nation-wide depression that was to last for several years. Although corn

prices enjoyed a sharp recovery in 1894, generally speaking farm prices remained low—wheat until 1896 and corn into the late 1890's or even later.

273. The Panic of 1893 was followed by a long period of business depression in the territory served by the U.P. In the years prior to 1893, this area had enjoyed a boom based on easy credit. Thousands of newcomers, many of them with very little agricultural knowledge or experience, had bought land at inflated prices, borrowing on it all the money they could get. Speculative syndicates bought immense tracts of land, mortgaged them for more than they were worth, cut them up into farms and sold them, or tried to sell them, to immigrants from the East. Even the established farmers borrowed millions of dollars on their holdings for the purpose of building houses and barns, acquiring additional land or purchasing live stock and machinery. Cities and towns in the agricultural area outgrew their former boundaries and expanded widely in suburban development.

274. When the Panic of 1893 came, with a sudden contraction in credit and a general loss of confidence in everything and everybody, the financial structure collapsed. Interest payments on speculative loans ceased; mortgages were everywhere foreclosed; farmers were unable to meet their engagements and a period of general embarrassment and distress followed the period of prosperity. The great tracts of land bought by speculative syndicates were no longer saleable and remained uncultivated; town sites were abandoned, and municipalities which had floated loans in the East ceased to exist, leaving the holders of their bonds to foreclose on deserted town lots and empty buildings. Settlers could no longer obtain bank accommodations; solvent businessmen suffered great losses from the sudden shrinkage in values; and even the population decreased as ruined farmers and unemployed farm laborers drifted back into the eastern states.

275. During the erosion of agricultural prices that started soon after Appomattox, discontent arose in the farm areas. Though there were periods of considerable prosperity because of bountiful crops, agricultural machinery, equipment and tools commanded high prices due to high tariffs and monopoly controls. In addition, property taxes were burden-

some and interest rates were high, ranging from 7 percent to 10 percent and even higher as a result of special charges. To add to the difficulties of the farmers, especially those in the western states, Congress in 1873 prohibited any further coinage of silver. Passage of the Bland-Allison Act in 1878, providing for limited coinage of silver, proved to be comparatively ineffective in strengthening farm prices.

276. The agrarian discontent found reflection in the Populist movement, called "the emphatic political expression of agrarian revolt," which had its origin in "Farmers' Alliances," though it also enlisted the support of industrial workers adversely affected by the depression which began in 1893. The Populist movement reached its peak in 1896; but when the Democratic Party nominated William Jennings Bryan as its candidate for President after his stirring "Cross of Gold" speech, the Populists embraced and supported his free silver program and other reforms.

8. *The Receivership of the U.P.—1893–1898*

(a) *Causes*

277. The predecessor Union Pacific went into receivership on October 13, 1893, a victim, with many other roads, of the Panic of 1893. Its financial troubles dated back to its capitalization, both original and as worsened by the consolidation in 1880.

278. With each passing year, the road was coming closer to the period when it would have to face up to heavy debt maturities, including publicly held bonds, as well as obligations due to the United States Government and interest thereon.

The principal early maturities of the predecessor held by the public at the close of 1892 were as follows:

Union Pacific Railroad Sinking Fund 8s 1893	$5,176,000
Union Pacific Railway Collateral Trust 6s Notes 1894	15,793,000
Kansas Pacific 1st Mortgage Eastern Division 6s 1896	2,240,000
Union Pacific Railroad Omaha Bridge 8s 1896	728,000
Kansas Pacific 1st Mortgage Division 6s 1896	4,063,000
Union Pacific 1st Mortgage 6s 1896–1899	27,229,000
Kansas Pacific 1st Mortgage Denver Extension 6s 1899	5,887,000

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Findings of Fact

Debt owed to the United States Government and due in the years 1895–1899, thirty years after it originally was incurred, amounted to $27,236,512 for the U.P. and $6,303,000 for the Kansas Pacific, a total of $33,539,512, exclusive of net interest accrued after deduction of the sinking fund established by law to meet the payments due the Government.

279. In summary form, the obligations of the U.P. at the 1880 and 1892 year ends were as follows:

	Dec. 31, 1880	Dec. 31, 1892	Increase
Funded debt	$82,623,114	$85,492,185	$2,869,071
U.S. Government debt	33,539,512	33,539,512	
Interest on Government debt less sinking fund	12,133,975	17,784,764	5,650,789
Total systems debt	128,296,601	136,816,461	8,519,860

280. Interest charges of the U.P. System in 1892 amounted to $5,371,587, exclusive of interest on the United States Government debt, compared with $5,288,788 in 1880 and $4,914,671 in 1881. In addition, interest requirements on the Government debt amounted at 6 percent per annum to $2,011,920 annually.

281. The direct causes of the U.P.'s receivership were the collapse in business conditions in the second half of 1893, sometimes called the Panic of 1893, and the expectation of a $3 million deficit for the year, after fixed charges.

Longer-range causes were the high cost of construction, the size of the debt owed to the Government, the restrictions on the road's financial freedom imposed in its charter to protect the Government, the burdens assumed in building branches, the debt assumed in the construction following the mergers in 1880, and the rate reductions and other measures undertaken to meet the competition of transcontinental roads.

(b) *Settlements*

282. The receivership continued from 1893 to 1898. The receivers were three in number at first, then five. Of the five, two specifically represented the United States Government, with a third also in something of a quasi-public role.

283. Shortly after the receivership began, a reorganization committee came into being at the instance of various classes of the road's security holders. Mr. J. Pierpont Morgan subsequently was added to the committee and proved to be a

dominant force in its decisions. This committee tried for two years to obtain approval of its successive reoganization plans, but the recalcitrance of Congress to the working out of a solution for handling the Government debt (eventually paid in full) caused it to abandon its efforts in March 1895. Mr. Morgan retired, disgusted with what he regarded as political intriguing which had blocked reorganization.

284. In the period of the first reorganization committee, the U.P. System shrank from 8,167 miles of road to 4,469 miles, with further shrinkage in prospect, in largest part due to the loss of branch lines of the U.P.'s system.

285. At this juncture, Mr. Winslow S. Pierce, chairman of the board of directors of the U.P., induced Mr. Jacob H. Schiff and his firm, Kuhn, Loeb & Company, to undertake reorganization. Mr. Schiff created a strong reorganization committee, including such influential people of the era as Mr. Chauncy M. Depew, president of the New York Central, and Mr. Marvin Hughitt, president of the Chicago and North Western Railroad, both regarded as associates of Commodore Cornelius Vanderbilt, prominent railroad magnate. The association in the public mind of the reorganization committee and such outstanding figures in the railroad world proved to be a constructive influence.

286. Undoubtedly, the biggest problem of the reorganization committee was to find a solution to the question of meeting the debt plus accrued interest owed to the United States Government. The Government proved to be a hard bargainer, for even after agreeing to accept $50 million for its claim, in late October, 1897, it refused to abide by its agreement. The reorganization committee then agreed to pay the Government in full, principal and interest, on the debt due on the original Union Pacific Railroad mileage—a total of $58,448,224, including the sinking fund of $18,194,618. On February 12, 1898, the committee also agreed to pay the principal amount of $6,303,000 due on the Kansas Pacific debt owed to the Government, but refused to pay the $6,588,900 of accrued interest. The latter sum, plus interest on this amount, remained as a claim against the receivership estate and ultimately was settled at $821,898.

The Government received a total of $65,573,122, far more than the reorganization committee or the Government directors on the Union Pacific board had had in mind as a probable settlement. For its second mortgage position, the Government appears to have come off quite well in being paid in cash for its entire claim against the main line and a substantial part of its claim against the Kansas Pacific.

287. In contrast with the liberal treatment obtained by the Government in the reorganization, holders of U.P.'s first mortgage bonds all agreed to make the sacrifices of a long-term extension—to 50 years—of their maturities, and a reduction to 4 percent in the rate of fixed interest to which they were entitled. On the old bonds the interest rates had been for the most part 6, 7 and 8 percent. In compensation for the extension of the maturity date and the reduction in interest on these new bonds, all bondholders other than the Government were given a substantial increase in principal, receiving new $100 par 4 percent preferred stock. They (the bondholders included in the reorganization) received (without other payment therefor) new preferred stock to the extent of at least 50 percent of the principal amount of bonds held; no class of old bonds received in new bonds and preferred stock together less than 150 percent of the par value of the old bonds, with a few minor exceptions. Holders of $36,440,950 publicly held bonds received in the aggregate $29,719,960 par value of new bonds, along with $26,841,775 in new preferred stock, a total of $56,561,735 in new securities, or 155.2 percent of the par value of the old bonds.

(c) *The Reorganization Plan*

288. In sum, the reorganization plan of the U.P., as finally adopted, provided for the issuance of $90 million in first mortgage and land grant 4s 1947 bonds, $75 million or 750,000 shares of 4 percent noncumulative preferred stock of $100 par value and $61 million or 610,000 shares of common stock of $100 par value. New common stock having a par value of $60,868,500 was delivered to holders of the common stock of the predecessor who paid an assessment of $15 per share. See finding 208.

As stated above, $29,719,960 par value of the bonds and $26,841,775 par value of the preferred stock were issued to bondholders of the Union Pacific Railway Company, other than the Government and collateral trust issues. Of the remaining securities of the reorganized company, $52 million of the bonds and $24,666,667 par value of the preferred stock were issued to the Purchase Money or Reorganization Syndicate in settlement of net cash advances of $46,940,000. Another $6,250,000 par value of the preferred was issued to the Purchase Money Syndicate and bankers as compensation for their claim of $2,500,000 for services, a sum which on division by the 62,500 shares issued gives a product of $40 per share. Another $2,122,000 par value of the preferred was paid to holders of Union Pacific 6 percent Collateral Trust Notes for the right acquired by the reorganization committee to purchase the collateral. Still another $9,103,658 par value of the preferred was issued at par to holders of the common stock of the predecessor for their payment of the cash assessment. The balance of the new securities were sold by the reorganization committee for cash or retained by the committee.

289. (a) The defendant's expert testified that

The issuance of 62,500 shares of preferred to the Purchase Money Syndicate and bankers as compensation for their claim for $2,500,000 for services was a valuation of the preferred at $40 per share.

(b) It is found that

The services of such a committee as was here involved are not ordinary personal services and are not purchasable in a competitive market. It would be more correct to think of the committee and the Syndicate as selling an asset going into the reorganization, for a block of stock. While the division of the shares into the dollar amount gives a seeming dollar figure per share, it is wholly artificial and the figure is not a market valuation or a valuation material in determining fair market valuation.

290. After commissions, the reorganization committee actually received $8,582,458.50 in cash as assessments on the old common. It should not be assumed that no other consideration was received for the $75 million in preferred

stock issued in the reorganization. A great deal of legitimate work unquestionably was performed by the reorganization committee and the Purchase Money Syndicate obligating itself to take large blocks of the new securities.

291. (a) The defendant's expert testified that

By no stretch of the imagination, however, could their services have been worth more than several million dollars, allowing for the risks assumed by the Purchase Money Syndicate and compensation in lieu of interest for the money furnished to the reorganization committee. In any event, the capitalization of the reorganized company, as stated on the books, was increased out of all proportion to the value of the services rendered. It should also be pointed out that had the U.P., through sound operation and financial management, been a prosperous and solvent railroad, it would have been able to refund its bond maturities of the 1890's, including the Government lien, at the low interest rates prevailing during the period and thereby have avoided completely the issuance of any new fictitious capital.

(b) The testimony that the services of the reorganization committee and the Purchase Money Syndicate were "by no stretch of the imagination . . . worth more than several million dollars" is not accepted. It is vague, subjective, unspecific and undocumented. The services of such committees are unique and costly. They were moreover presumably approved by the reorganization committee. No basis, intrinsic or extrinsic, appears for the derogations by the witness of the value of the services.

The testimony that the U.P. could have avoided the issuance of any "new fictitious capital" had it been a prosperous and solvent railroad through sound operation and financial management is also not accepted. Many railroads went into reorganization at the time. The Panic of 1893 was not the fault of the U.P.'s management. The U.P.'s insolvency had roots as far back as the original conditions upon the Government's assistance. Insolvency and reorganization were the facts. The reorganization plan was a good one and successful, and made it possible for the U.P. to proceed to profitable operation, free of the burdens of its past. It was to be expected that there would be substantial payments for the additions to

value brought about by the reorganizers and their committees and syndicates in the form of capital stock paid to the reorganizers, stock which proved not to be a burden on the company.

Finally, in view of the foregoing, the witness' further conclusion—that the capital of the reorganized company was increased disproportionately—is also not accepted.

(d) *The End of Reorganization, January 31, 1898*

292. The Union Pacific emerged from receivership at midnight at the end of January 31, 1898, with the acquisition by the present plaintiff, the taxpayer, from the reorganization committee of the property sold on foreclosure, including the main line of 1,043 miles from Omaha to Ogden, Utah. On April 1 of the same year, the road reacquired the 806 miles of the lines of the Kansas Pacific.

293. No balance sheet was included in the annual report of the predecessor U.P. for the year ended December 31, 1897, and it is thus impossible to determine the amount of any property write-up between December 31, 1897 (a date close to the January 31, 1898 effective date of the reorganization) and June 30, 1898, the date of the first balance sheet of the reorganized company, the taxpayer.

Comparison of the balance sheets for December 31, 1896 and for June 30, 1898 shows that in the elapsed year and a half road and equipment had been written up, as of the latter date, $65.9 million, from $155.4 million to $221.3 million.

The 1896 report also contained separate or additional items labeled "Receivers Union Pacific Railway Co., Property Account, $3,787,203.71" and "Land Contracts, Land Cash, etc., $6,171,303.43." The first of these two items, to the extent acquired by the taxpayer, may have been included in the property account of the taxpayer. Whether the land assets of the predecessor were included in the road and equipment account of the taxpayer on June 30, 1898 is not clear, but presumably they were not. The item does not otherwise appear in the 1898 balance sheet. The land assets did not show up until June 30, 1899, when they were reported as follows: "Land Assets, $3,002,232.29."

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Findings of Fact

294. The reorganized road disclosed in its first balance sheet, dated June 30, 1898, that the following securities were outstanding: funded debt of $90 million, $75 million 4 percent noncumulative preferred stock of $100 par value, and $61 million common stock of $100 par value.

295. The reorganization meant a great improvement in the condition of Union Pacific at the time of the reorganization in 1898. All debt was consolidated into one long-term issue, and by the same token there was no problem of short-term or floating debt, which in that era often was a threat to solvency.

296. The emergence of the U.P. from reorganization, moreover, came at the beginning of a wave of prosperity for the nation and particularly for transcontinental railroads.

(e) *Receivership and the U.P.'s Branch and Subsidiary Lines*

297. The branch line system had disintegrated rapidly during receivership. As the U.P's trustees defaulted on interest payments on the road's collateral trust issues, which were secured by pledges of securities of the branch line subsidiaries, the trustees under the indentures sold the collateral. In 1893 the trustees under these indentures sold collateral consisting of securities of 13 branch lines with a par value of $5.2 million and a book cost of $4.9 million. In turn the subsidiaries went into receivership.

Without these branch and subsidiary lines, a reorganized U.P. would be a truncated main line railroad. The reacquisition of these lines, following their and the U.P.'s reorganization, was of the utmost importance to the reconstitution of the pre-receivership U.P.

It is not entirely clear, and not material, whether the defaults on the securities which put the branches and subsidiaries into receivership were in the ultimate sense voluntary or involuntary. One view is that the defaults were involuntary—that the money was simply not available. Another view is that defaults would in any case have been allowed to happen, to force a reorganization of the branches and subsidiaries, all separate corporations, which would purge them of their heavy debts and shrink their watered capital.

298. Whichever view is correct, it was the underlying intention and plan of those prominent in the affairs of the U.P.—receivers, reorganizers, investors, bankers and prospective leading figures in the new company—to keep close and friendly contacts with the former branches and subsidiaries of the U.P. in order to protect the U.P.'s traffic and then to reacquire those branches and subsidiaries for the U.P. to reconstitute the U.P. network. In pursuance of this plan, the U.P.'s reorganization committee took an early part in the reorganization of the former branches and subsidiaries and purchased interests in them.

299. In this way or another, most of the branch and subsidiary line mileage (except for a good part of the mileage of the Union Pacific Denver and Gulf) was reacquired by the U.P., most of it shortly after consummation of the receivership in January 1898, the rest in 1899. Most of these lines were reacquired from the U.P.'s own reorganization committee, which had acted on behalf of the new corporation (the present taxpayer), which would take over the U.P. property.

9. *Post-Reorganization Prosperity*

(a) *National Prosperity*

300. With the defeat of Bryan in 1896 and the election of William McKinley on his (or Mark Hanna's) strong endorsement of the gold standard, high tariffs, and support of business, the nation emerged from a period of political uncertainty and moved into an era of generally sustained and rising prosperity until the Panic of 1907.

301. In marked contrast to earlier times, the years after the reorganization of the Union Pacific were very prosperous. Between 1900 and 1910, the population of the trans-Missouri states increased about 40 percent, while the increase in the value of farm lands along the lines of the Union Pacific ranged from 100 to 353 percent. This enhanced value of farm lands was partly due to better and more extensive cultivation, and partly to a greatly improved railroad service which enabled the farmers to send their crops cheaply and promptly to markets where there was an active demand for them. The annual value of these crops, in the states directly tributary

to the Union Pacific, increased in the decade 1899–1909 by percentages that ranged from 89 to 235.

302. Agricultural crops, however, were not the only western products that needed transportation. In the revival of business that followed the reorganization of the U.P., industrial activity increased rapidly in all the far western states, and between 1900 and 1910 the annual value of manufactured products in Union Pacific territory rose from $257,000,000 to $530,000,000 in California; in Colorado from $89,000,000 to $130,000,000; in Idaho from $3,000,000 to $22,000,000; in Kansas from $154,000,000 to $325,000,000; in Nebraska from $13,000,000 to $199,000,000; in Utah from $18,000,000 to $62,000,00; and in Washington from $71,000,000 to $221,000,000. This group of states alone, in 1909, produced manufactured goods valued at $1,500,000,000, as well as farm crops to the value of $672,000,000 more.

303. Business conditions were given further sharp stimulus with the involvement of the United States in war with Spain in 1898. Then upon its conclusion, annexation of the Philippines by the United States—and the unrelated annexation of Hawaii—resulted in a tremendous expansion of trade with these new territories. In addition, trade with the Orient generally rose to a substantial degree. This was of especial benefit to the transcontinental railroads. In the 1900's, prior to the Panic of 1907, there was an all-pervading aura of prosperity occasioned by favorable business, good farm crops and prices, corporate mergers, and high earnings. Even the Panic of 1903—essentially a rich man's panic that hardly touched the nation as a whole—failed to stop the upward course of the boom at the turn of the century.

304. The statistics in the foregoing from the decade 1899–1909 or from 1900–1910 are not intended to negative the finding that the returning wave of prosperity began in 1896, and was thus underway at the time of the reorganization of the U.P. in 1898. It has been said that fortune smiled on the Republican party after McKinley's election.

(b) *The U.P.'s Increasing Prosperity*

305. Edward H. Harriman became chairman of the Union Pacific's executive committee in May, 1898, when he was just

short of 50 years old, and later chairman of its board, president and chief executive officer. He first came to the U.P. in 1896 from successes with other railroads, and since that time he had been a director and member of the advisory and executive committee and closely involved with Jacob H. Schiff of Kuhn, Loeb & Co. in the reorganization committee and a large participant in the Purchase Money Syndicate.

Harriman had during the reorganization made clear his intention to take control of the road, and he soon came to dominate the Union Pacific, from about 1897 (and possibly earlier) until his death in September of 1909.

His remarkable personal qualities—prodigious memory, capacity to marshal facts, good judgment, courage in large business decisions—were exercised on behalf of the U.P. to its great profit, until the Panic of 1907.

306. He had a large personal stake in the Union Pacific—stock acquired mainly at low prices beginning in 1898; and by the dynamic character of his operations he brought into the company many millions of new capital. His purchases of interests in other railroads for the U.P. and his improvements of the U.P. were undertaken in a period of almost uninterrupted business improvement and prosperity. Business, as defendant's expert testified, was consistently good from 1897 to 1907.

Harriman brought great profit to the Union Pacific in the time of his administration, until the Panic of 1907, followed by his death not long thereafter.

Some measures of the U.P.'s improvement during Harriman's leadership are that in the period 1900–1906 its gross earnings increased nearly 42 percent and its net earnings increased 69 percent; its income from investments increased from $2.7 million to $10.3 million; and its net income available for dividends increased by $19.2 million or 152 percent.

Dividends on the 4 percent preferred began in 1899, in the first full fiscal year following reorganization, with a 3½ percent dividend (on the par of $100).

Dividends on the common began in 1900 with a payment of 3½ percent (on the par of $100), went to 4 percent in 1901, to 4½ percent in 1905, to 6 percent in 1906 and, a major feat for Harriman, to 10 percent in 1907.

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Findings of Fact

Improvement in the very first years and the foreseeability in January 1898 of improvement brought about by Harriman are the subject of following findings.

307. Correctly judging that the depression had run its course in 1896 or 1897 and would soon be followed by a new wave of prosperity, Harriman's first venture on behalf of the U.P. was a renewal in 1898 of U.P.'s plant. The decision to spend the very large sum involved was the product of a characteristic combination of his prosaic belief in good maintenance, efficiency and fine equipment, his excellent judgment in matters of economic forecasting and his courage in risking large sums on grand plans.

While the road was in good condition in 1887, it had deteriorated during the receivership, and Harriman found it in need of much rehabilitation when he made a daylight inspection trip of the Union Pacific, Oregon Short Line and Oregon Railroad and Navigation and proposed by wire and by letter a $25 million rehabilitation program. So great was his confidence in the outlook for a new wave of prosperity and in his own judgment that he ordered millions of dollars worth of materials and supplies before obtaining approval of the board of directors on his return. The board acquiesced, though some misgivings were expressed, and Harriman's program was ratified. (No finding is made on the dates and details of the events in this paragraph because the sources are contradictory and unreliable.)

Harriman proved to be right in his views that the Union Pacific should prepare for coming prosperity before its rivals by improving its roadway and buying more powerful locomotives and bigger cars. Through expenditures of $45 million in the years 1898–1902, the Union Pacific System placed itself in an impregnable position to handle the rising volume of traffic that followed the acceptance of the gold standard in 1896 and strong foreign demand for the nation's rising wheat crops.

Harriman continued to plow back the rising earnings of the Union Pacific until the road was regarded as one of the finest in the world. There can hardly be any question but that under the excellent management of Harriman the Union

Pacific enjoyed a rapid metamorphosis from a rundown railroad to one of superior standards.

308. At the same time that Harriman was demonstrating his soundness in the rehabilitation and operation of the U.P. he was planning great enlargements of the road's sphere of influence such as the acquisition of majority or controlling interests in the Southern Pacific, the Northern Pacific and the Chicago, Burlington and Quincy.

The Southern Pacific owned the Central Pacific, which connected with the Union Pacific at Ogden to make a continuous road to San Francisco, and it also controlled the Pacific Mail Steamship Co. The Northern Pacific controlled the Burlington, a competitor in the Union Pacific's own territory.

309. Harriman's acquisition of the Southern Pacific was disclosed in January, 1901, when it appeared that on behalf of the U.P. Kuhn, Loeb & Company had purchased $75 million par value of Southern Pacific's stock, at under 50 percent of par, of the total of $197.8 million outstanding. Another $15 million par value was purchased by the Union Pacific approximately a year later.

310. To finance the initial purchase and for other corporate purposes, the Union Pacific offered $100 million par value of First Lien Convertible 4s, due May 1, 1911. The approximate market value of the assets conveyed under the indenture was $107,565,800, or only about 7½ percent in excess of the par value of the bonds issued. The $75 million of Southern Pacific stock just acquired and pledged was at that time carried at $50 per share, or a little more than its market value at the time.

The new Union Pacific bonds were convertible at the option of the holder into Union Pacific common stock, at the rate of $100 face amount of bonds for one share of $100 par value stock. On the issue of the bonds, Union Pacific received $100 million in cash, less a commission of $2 million.

311. The investment in the Southern Pacific soon, as will appear, enabled the Union Pacific to make a huge amount of profit which it turned to advantageous reinvestment from the standpoint of current income, which in turn permitted the payment of liberal dividends.

312. In the next year after the Southern Pacific acquisition in 1901, Harriman began a battle with J. P. Morgan and his ally James J. Hill to obtain for the U.P. an entrance into Chicago by gaining control of the Chicago, Burlington & Quincy.

313. Briefly, Great Northern and Northern Pacific had in 1901 obtained control of the Chicago, Burlington & Quincy. When the two Northerns refused to include the Union Pacific as a participant in the acquisition, Harriman attempted to buy into Northern Pacific to obtain control of it and thereby achieve his objective as to the Burlington. Had he succeeded, he would have had an equal interest with Great Northern in the Burlington.

A buying contest ensued; J. P. Morgan and Great Northern also bought heavily into Northern Pacific. Although Union Pacific acquired a larger interest in the Northern Pacific than the Morgan-Hill group did, the Morgan-Hill group controlled the common and had the right to call the preferred, and the U.P.'s interest was reduced to a minority position through redemption of the preferred stock.

314. The Harriman interests still owned a large block of Northern Pacific common stock and a compromise was effected with the Morgan-Hill group, creating the Northern Securities Company to hold control of both Great Northern and Northern Pacific and thereby hold control of the Burlington. When Northern Securities Company was held by the United States Supreme Court in March 1904 to be a combination in restraint of trade, its holdings of Northern Pacific and Great Northern were distributed pro rata, rather than returned as originally contributed by the parent roads. *See Northern Securities Co.* v. *United States*, 193 U.S. 197 (1904); *Harriman* v. *Northern Securities Co.*, 197 U.S. 244 (1905). The net effect was that the Union Pacific received interests in the two roads which while substantial were inadequate for purposes of control.

Thereafter very large profits were realized from the sale of the securities distributed by the Northern Securities Company.

315. A series of complex financial transactions was the source of the funds to finance the original purchase of North-

ern Pacific stock, the $15 million additional Southern Pacific stock referred to in finding 347, advances of $20,462,927 to that company, advances of $5,055,311 to Pacific Mail Steamship Company, and acquisition and construction of the San Pedro, Los Angeles and Salt Lake Railway Company at a cost of nearly $20.5 million. The bulk of the money came from the $100 million convertible bond issue sold immediately after the initial commitment to buy $75 million par value of Southern Pacific stock at something under 50 percent of par. Substantial funds apparently also were obtained from banks, and the road's net floating debt on June 30, 1901, was $30,249,459 larger than a year earlier.

Title to the Northern Pacific shares actually was vested in the Oregon Short Line, which obtained funds from Union Pacific by issuing to it purchase money certificates of indebtedness for $61 million. In addition, Oregon Short Line in 1903 issued $36 million 4 percent and participating collateral trust bonds.

316. The net effect of the foregoing and other transactions was that as of June 30, 1904, the Union Pacific had outstanding consolidated net indebtedness of around $289 million, compared with about $149 million on June 30, 1900, before Harriman's plans got underway. The net debt of the U.P. thus rose in this 3-year period, mainly to finance these ventures, by roughly $140 million, or approximately 93 percent.

317. The Southern Pacific did not pay dividends, and it required substantial physical rehabilitation. The impressive improvement in earnings was the chief support for the $4 million of interest called for annually by the bond issue issued to finance the S.P.'s acquisition. In U.P.'s ownership, the S.P. stock produced by June 30, 1901, equity earnings of $4,447,500—$5.93 per share on the 750,000 shares of S.P. purchased in that year, or $4.36 per share on U.P.'s outstanding common. Moreover, the interest requirement diminished as, increasingly, the bonds were converted into common stock pursuant to the option attached to the bonds.

318. Indeed, the rate at which the privilege of conversion was exercised by the holders of the 4 percent bonds issued to finance the Southern Pacific acquisition (finding 310) was an index to the steady improvement in the Union Pacific's

position in this period. Only $12.7 million face amount of these bonds had been converted as of June 30, 1904. Another $56.1 million was converted in the fiscal year ended June 30, 1905, and another $32.7 million was converted after the increase of the dividend on the common from a 4 to a 5 percent basis in October 1905 and to a 6 percent basis in April, 1906. As of August, 1906, all except $500,000 face amount of these bonds had been converted.

319. (a) The defendant's expert testified that the impressive improvement in U.P.'s earnings which supported the interest requirements on the bonds issued to finance the Southern Pacific acquisition was not generally foreseen.

(b) It is found that the impressive improvement in earnings, while in its full extent not generally foreseen, was as a trend foreseeable by a reasonably informed investor. The significance of the acquisition of the Southern Pacific as a source of business and profit for the U.P. was foreseeable; and the reasonably aware investor could appreciate the context—the management's continuing and successful efforts to reconstitute the Union Pacific System, in a setting of increasing national prosperity.

320. (a) The defendant's expert testified that

Harriman's ventures entailed tremendous financial risks and that had he not engaged in them the Union Pacific no doubt would have been a highly prosperous property in its own right, for nothing of a permanent nature was realized from an operating standpoint from Harriman's financial escapades.

(b) It is found that the ventures were risky only in that they were of very large scope; that the ventures cannot be described as "financial escapades"; that they were sound, foreseeably profitable to U.P. and that the profits were soon realized; in short, that the ventures were exceedingly good investments—"eminently successful" and the source of a "fabulous" amount of profit for the U.P., as defendant's expert testified—which enlarged the Union Pacific's system and in a remarkably short time brought it profit from an operating and investment standpoint.

321. (a) Defendant's expert testified that

Harriman had "speculative leanings"; that he was "auda-

cious"; that his ventures were "risky," "daring," "escapades" and "forays."

(b) It is found that these and other depreciations of Harriman are without basis and unwarrantedly seek to minimize the value to the U.P. of his management talents and the reflection in the value of U.P.'s stock of the profits he brought to the U.P.

322. (a) The defendant's expert testified that

Harriman correctly judged the upturn in business conditions in 1897, and yet testified that if business conditions had not been consistently good from 1897 to 1907 some of Harriman's escapades could well have plunged the U.P. into trouble again.

(b) It is found that the conclusion in the foregoing subparagraph (a) is rejected as an improper characterization of Harriman's sound and successful business steps and as an effort without basis to deprive the valuation of the U.P. stock of the value of Harriman's talents and successes.

323. (a) The defendant's expert testified that

Harriman's successes hardly alter the conviction that he risked the future of the Union Pacific from the standpoint of finances, operations and the public interest; that his ventures heavily involved the Union Pacific's credit and financial integrity, and could have been as disastrous as they were in fact ultimately profitable.

(b) It is found that there is in the record no data, other than the mere size of the ventures and the sums involved, to support the conclusions in the foregoing subparagraph (a). Superbly planned and executed ventures by all but inspired corporate leadership, so soon and so successful as these were, cannot be denigrated with the cliche that any venture can fail.

This is not to say that the value of the corporate stock at the beginning of such ventures is to be measured by the full actual success later realized. The reasonably good prospects for the success of the ventures must, however, go into the scales in the valuation.

324. Harriman's period of management was one of improvement in U.P.'s value generally, and not only in consequence of his acquisitions of interests in Southern Pacific, Northern Pacific and Burlington. The improvement could

be seen in the brief year between the effective creation of the new company on January 31, 1898 and the exchange offer of the Oregon Short Line stock on January 26, 1899 (finding 424 et seq.). In that period alone, the U.P. became a considerably stronger road.

The prospects of this improvement were to a degree foreseeable by reasonably informed investors in January 1898, by reason of the knowledge available to and in the financial community, which knew of Harriman's talents and had witnessed since 1896 his increasing degree of leadership of the U.P.

325. (a) The defendant's expert testified that

While the financial condition of the U.P. was good at the time the reorganization became effective in January, 1898 (see finding 295), the current financial position of the reorganized road as of June 30, 1898, was not robust, for current assets of $7,598,045 exceeded current liabilities of $4,468,416 by only $3,129,629. A year later, the balance sheet showed an excess of current assets over current liabilities of only $1,109,098. Moreover, the liability side did not include a dividend of $1,500,000 declared on the preferred, which was payable in cash on October 2, 1899. A significant change for the better took place in the current financial condition of Union Pacific during November 1899, when the receivers of the old Union Pacific Railway Company made a cash distribution on claims against that company. The plaintiff's proportion amounted to $5,249,090, which, together with the balances in the treasuries of Oregon Short Line and Oregon Railroad and Navigation Company, gave the combined system a cash balance of $11,385,793 on December 1, 1899. By June 30, 1900, the situation was not so favorable again. Cash and cash items had dwindled to $7,957,896 and in addition station agents and conductors held cash of $579,363. Including these items and accounts collectible of $3,027,350, total current assets amounted to $11,564,-610. Current liabilities totalled $7,486,611, leaving what the road called "Balance, Cash Assets" in the amount of $4,077,-999. Additionally, the liability side of the balance sheet listed interest and sinking funds accrued but not due in the amount of $449,538 and dividends payable of $3,904,146 on October 1, 1900. On June 30, 1901, Union Pacific was run-

ning extremely serious financial risks inasmuch as on a consolidated basis it had a net deficit of $25,779,808 in working capital and also had declared dividends of $4,071,006 payable October 1, 1901. This abrupt decline in its working capital position was due to plaintiff's acquisitions of stock in the Southern Pacific and Northern Pacific, as described above.

(b) The foregoing testimony and conclusion in the foregoing subparagraph (a) are rejected as misleading.

(1) Any implication that the condition or value of the Union Pacific worsened following the reorganization would be incorrect. The reorganization was a good one, the cash position of U.P. was reasonably good and its credit was good, and its general condition kept constantly improving from the moment the reorganization was effected.

(2) The quality of the risks in the acquisitions of the Southern Pacific and Northern Pacific have been discussed above; the risks were not, as the witness implies, serious. The obligations assumed and the effect on cash in consequence of these investments did not create "serious financial risks" but were good business.

(3) The approximate size of the distribution of such a sum as the $5,249,090 distributed to the Union Pacific by the receivers was doubtless foreseeable and known well in advance, on the basis of management's and investors' knowledge of the relationship of the total claims to the amount of assets to become available for satisfaction of the claims. The exact sum may not have been foreseeable and forecast, but that a claim would be paid, and its magnitude, would have been known long in advance.

10. *Approaches by the Government to Valuation of the Reorganization Stock*

(a) *Propects for Reacquisition of the Oregon Lines*

(i) *History of the Oregon Lines*

326. The Oregon Short Line Railroad was organized in February 1897 as the successor to the Oregon Short Line and Utah Northern Railway Company, which had been sold under foreclosure in January that year. The prop-

erties—primarily a road from Ogden to the Idaho-Oregon border—were turned over to the new company on March 16 of the same year.

The predecessor, the Oregon Short Line and Utah Northern, had its beginnings in 1881 as the Oregon Short Line Railway Company. The last-named had been created by the Union Pacific to provide it with a connection with the Oregon Railway and Navigation Company, organized in 1879 and still in the blueprint stage but planned to run from the Idaho-Oregon border to the coast.

In 1889, the plaintiff's predecessor, which owned a large majority of the outstanding Utah and Northern Railway bonds and stock, merged the Utah and Northern with the Oregon Short Line, thereby creating the Oregon Short Line and Utah Northern. The latter, on December 31, 1896, owned $13,006,678 of the outstanding $24,000,000 stock of the Oregon Railroad and Navigation Company, of which $13,000,000 was pledged under its collateral trust 5s 1919 and the remaining $6,678 with the Union Pacific.

Other lines merged into the Oregon Short Line and Utah Northern were the Idaho Central and the Utah Central, the latter itself a consolidation of the Utah Central, the Utah Southern, and the Utah Southern Extension Railroads.

327. As earlier indicated (finding 258) the Oregon Short Line was financed by the issue of $29 million in securities, half in bonds and half in stock, 50 percent of the stock being issued as a bonus to the purchasers of the bonds and the other 50 percent of the stock being issued to the plaintiff's predecessor for no consideration.

328. The cost of construction was $14.5 million, half the $29 million capitalization. Bonds in the amount of $14,931,000 were issued to finance the cost, and were sold at face. (See finding 258.)

Expenditures for new construction to December 31, 1886, amounted to $3,379,405.56 for the Utah and Northern Railway and $890,978.92 for the Utah Southern. Information on other expenditures is not available.

329. At the time of the reorganization of the Oregon Short Line and Utah Northern in 1897, the road had outstanding $36,794,000 mortgage bonds, which, in view of the practice

of using the bonds to finance construction and issuing the stock as a bonus, probably represented the true cost of construction of the various lines comprising the property. In addition, the Oregon Short Line and Utah Northern had outstanding $13,000,000 collateral trust 5s 1919 secured by an equal amount of Oregon Railroad and Navigation Company stock. In the reorganization, the Oregon Short Line issued or assumed $34,054,000 fixed interest bonds and $22,026,000 income Series A and Series B bonds, the Series B issue of $14,841,000 being secured by the Oregon Railroad and Navigation Company stock. Pursuant to the plan of reorganization, bonds with a face value of $21,755,000 remained undisturbed and other mortgage bonds with a face value of $14,370,000 received 50 percent in new Oregon Short Line consolidated mortgage 5s 1946, 50 percent in new income Series A bonds, and 100 percent in new common stock. Holders of the $26,180,200 old common stock received one-half share of new common stock upon payment of an assessment of $12, for which holders received an equivalent par value in the new consolidated 5s. Scaling down of the old common stock by 50 percent had the effect of squeezing $13,090,100 of water out of the old capitalization, but this was in substance offset to the extent of $14,370,000, representing the amount by which new securities given to the aforementioned "other mortgage bonds" exceeded their face value, although there was some consideration in the form of lowered interest and acquiescence in new extended maturity dates.

330. Accordingly, the total cost of road and equipment of $67,508,189 appearing in the Oregon Short Line balance sheet of June 30, 1898, was probably still overstated despite the reorganization, in the light of the water in the capitalization of the original Oregon Short Line and the probable water in properties added to it.

331. The Oregon Railway and Navigation Company was in receivership from October 13, 1893, to August 17, 1896, and was then reorganized under the name of the Oregon Railroad and Navigation Company. The new company issued bonds having a face value of $20.1 million, $11 million par

value of preferred stock, and $24 million par value of common stock.

(ii) *The Oregon Lines in 1898*

332. There can hardly be any question that the Oregon Short Line occupied a most strategic position from the standpoint of the Union Pacific. With the Oregon Short Line and the Oregon Railroad and Navigation Company as part of its system, the U.P. had a line to the Pacific Coast; without these two Oregon lines, the U.P. terminated at Ogden and was in a very weak position in interchange traffic, particularly the transcontinental movement. The reacquisition of the Oregon Short Line, lost or deliberately let go in the reorganization (finding 297), as well as other parts of the old Union Pacific system, was therefore essential to protect the position of the U.P.

333. As far back as early 1896, Mr. Mink, then one of the receivers of the Union Pacific, stated that while the U.P. reorganization plan did not specifically provide for inclusion of the Oregon Short Line, "There is a strong probability that we shall retain it." At another point, Mr. Mink said, "I think that the loss of the OSL would be almost irretrievable." On October 30, 1897 it was reported that the reorganization committee had "comprehensive plans" for recovering the "old Union Pacific system."

334. (a) The defendant's expert testified that

(1) Of the $27,460,100 par value of common stock issued in 1897 by the reorganized Oregon Short Line, $8,460,000, or 84,600 shares, was acquired by the Union Pacific reorganization committee in December, 1897. This stock was purchased by Kuhn, Loeb & Company, representing the reorganization committee, from the trustees of the collateral trust 6 percent Notes due 1894. From all indications, the assessment on the old Oregon Short Line and Utah Northern stock had been paid, apparently by the trustees of the 6 percent Gold Notes.

(2) In March, 1898 the committee increased its holdings of Oregon Short Line common, and as of March 28, 1898, held a total of 120,093 shares at an average cost of $21.10 per share, including interest and commissions. These shares were transferred to the Mercantile Trust Company under a

syndicate agreement which apparently gave the Union Pacific the right to purchase this stock. Within the next several months, additional Oregon Short Line stock was purchased, and, at the end of August, 1898, the Union Pacific and Kuhn, Loeb agreed that the latter would buy for $3 million (or approximately $23.73 per share) the 125,679 shares of Oregon Short Line common then held by the Trust Company plus 750 shares to be acquired by the Union Pacific. A condition of the sale was that Kuhn, Loeb had the right to resell this stock to the Union Pacific prior to December 31, 1899, for its cost of $3 million plus interest of 5 percent.

(b) The foregoing testimony is rejected as materially incorrect and misleading. It is found as follows:

(1) Pursuant to the plan to reacquire the U.P.'s subsidiaries (findings 298, 299) the U.P.'s reorganization committee had bought up foreclosed Oregon Short Line stock and by December 1897 it had acquired 84,600 shares of the 274,601 shares of the reorganized Oregon Short Line from Kuhn, Loeb & Co., who were acting as bankers and financial agent for the committee. The shares remained with Kuhn, Loeb & Co. as security for the purchase price.

(2) The committee was acting on behalf of the new company which would acquire the road, that is, the new U.P., the present plaintiff. An agreement of February 23, 1898, which recites the purchase and makes further purchases, of which more below, disclaims personal liability of the members of the committee. The members promised only that they charged funds at their disposition with the agreement and that they would cause the new U.P. to agree to pay the monies due under the agreement and to assume performance of the agreement.

(3) It appears from the recitals in the agreement that Kuhn, Loeb had as of that date, February 23, 1898, bought additional Oregon Short Line common shares (whose number is not given throughout the agreement) which the committee desired to purchase, and that the committee desired Kuhn, Loeb to purchase for its account still further shares, which together with the 84,600 and the "additional" shares would aggregate 137,301 shares.

1

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(4) The agreement then goes on to provide that Kuhn, Loeb hereby sell to the committee, and the committee purchases, all the said shares of Oregon which have been purchased by Kuhn, Loeb in addition to the 84,600 already belonging to the committee, for a consideration of cost plus $1 per share for each share beyond the 84,600; the same rate was to be paid for the still further shares mentioned above.

(5) As of March 28, 1898, a settlement of accounts under the February 23 agreement among Kuhn, Loeb & Co., the committee and the U.P., showed the total number of shares "purchased under the agreement of February 23, 1898" to be 120,093, for which the committee owed Kuhn, Loeb $2,533,608.25. It does not appear how many of these, beyond the original 84,600, were the "additional shares" sold to the committee by the agreement of February 23, 1898, and how many were bought between February 23 and March 28.

(6) It is therefore apparent that a part of the shares additional to the first block of 84,600 had already been purchased by Kuhn, Loeb prior to February 23, 1898, and thus perhaps even prior to the effective date of the reorganization, January 31, 1898. In view of Kuhn, Loeb's position in the reorganization, any such shares would have been bought with a view to resale to the new U.P. or at least control by the U.P. as part of the plan for reacquisition of the Oregon lines.

(7) The said 120,093 shares of Oregon Short Line, with others to a total of 125,679, were transferred to the Mercantile Trust Company to be held by it as trustee under an indenture called the Auxiliary Lines Syndicate Agreement of March 28, 1898. The function of the Mercantile Trust Company was apparently to act as trustee for the interested parties—those whose money had paid for the stock and the U.P., which had a right to delivery on payment of the stipulated price.

(8) The agreements mentioned in the foregoing were ratified by the U.P. on April 7, 1898.

(9) On August 29, 1898, the U.P. transferred its right to delivery of the said 125,679 shares and sold 750 additional Oregon Short Line shares just acquired—a total of 126,429

shares—to Kuhn, Loeb & Co., who paid $3 million for them, Kuhn, Loeb & Co. to have the right of reselling them to the U.P. at any time between August 30 and December 31, 1899 at cost plus 5 percent interest.

(10) The U.P.'s reason for the transaction does not seem to have been any shortness of funds. There is affirmative indication in the relevant correspondence that the U.P. was not in need of money. The motive for the transaction does not appear from the scanty papers which have been available for the record in this case; it may have been designed with a view to the soon to be announced offer to exchange U.P. stock for Oregon stock (finding 386), and to facilitate the public response to the offer.

(11) Whatever the precise reason for the transaction, however, it is clear that the shares—both those bought before and after January 31, 1898—were safe for U.P.'s interest with Kuhn, Loeb. In view of the long standing plan of the reorganization committee, led by Kuhn, Loeb, to reacquire the U.P.'s subsidiaries for the U.P., the relations between the parties, the U.P.'s overriding need for the Oregon stock and its apparently adequate financial means at the time, the apparent sale of August 29, 1898 was not a sale of the Oregon shares out of the U.P.'s control, away from the U.P. system or in any way a setback in U.P.'s program to reacquire the Oregon lines, but merely a formal and temporary deferment of open ownership of the stock by the U.P. Control of Oregon had been assured to the U.P. by the earlier buying campaign.

335. (a) The defendant's expert testified that

As of January 31, 1898, the reacquisition by plaintiff of the Oregon lines was probable, but by no means certain. Something might have occurred to prevent reacquisition by the plaintiff. The reorganization committee's 84,600 shares of Oregon Short Line common were only about 30 percent of the 274,601 shares outstanding and not a majority, and there were others seeking control of the Oregon Short Line. As for the Oregon Railroad and Navigation Company, it was controlled not by the Oregon Short Line, but by the Great Northern and the Northern Pacific through ownership of

two-thirds of the Navigation Company preferred which was subject to a voting trust agreement. Moreover, little value can be assigned to the prospect of reacquisition. As of January 31, 1898, the Oregon Short Line did not have much earning power. Secondly, the terms of reacquisition were not predictable. It was the reorganization committee, not the plaintiff, which owned the 84,600 shares of Oregon Short Line common. Any benefit to be derived from reacquisition depended to a major extent upon the price the plaintiff would pay for the stocks of the two Oregon lines and the terms of the payment. Finally, reacquisition of the Oregon Short Line without the Oregon Railroad and Navigation Company would have been of little value because the Oregon Short Line ended at the Idaho-Oregon border and did not extend to the west coast.

(b) The foregoing testimony and conclusion are rejected. It is found as follows:

(1) As of January 31, 1898, reacquisition by the new U.P. of the Oregon lines on reasonable terms was substantially certain; further, the Oregon lines had good earning power and were essential to the prosperity of the U.P.

(2) Throughout the receivership it was planned and anticipated by the receivers and the committees and leading figures in the reorganization that the U.P. would be able to and would acquire the Oregon lines. In carrying out this plan the reorganization committee was acting on behalf of the new U.P.; the committee's ownership was the U.P.'s ownership. Kuhn, Loeb, too, bankers to the reorganization, was involved in the reorganization in the interest of the U.P. Both the committee and Kuhn, Loeb were engaged in a program of acquisition of Short Line stock on behalf of and for the account of U.P. for purposes of eventual control by the U.P. There is nothing of substance in the record to show that the U.P. had rivals in this program or that there were any substantial obstacles to its success. While the committee may not have had an absolute majority of the Short Line stock by January 31, 1898, it definitely had 84,600 shares, ordinarily a number large enough for control. Moreover the

"additional" shares which the committee bought from Kuhn, Loeb on February 23, 1898 may already, on January 31, 1898, have been in the hands of Kuhn, Loeb, and in those hands safe for use in the U.P.'s reacquisition of the Oregon. Further, by March 28, 1898 the shares accumulated for the committee—shares of which U.P. was the beneficial owner, albeit subject to payment of their cost—totaled 120,093. These various transactions, even including the accumulation of 120,093 by March 28, 1898, were substantially contemporaneous with the effective date of the reorganization and thus any valuation of U.P.'s stock as of January 31, 1898 should be based on U.P.'s ability to control shares to this number.

(3) The reacquisition was of great value to the U.P. It is incorrect to say that as of January 31, 1898 either of the Oregon lines did not have much earning power. They had been out of reorganization for some time, favorably recapitalized, and launched on successful money-making courses. See findings 391–407. And aside from the Oregon lines' ability to make money on their own mileage, they were, as defendant's expert admitted, most strategic and essential for the U.P., and so aside from their own earning power, they were undoubtedly of great value to U.P.

(4) It is incorrect to say that the terms of reacquisition were not predictable and that benefits would depend on the price fixed by the reorganization committee, the owner of the stock. The reorganization committee was acting as agent for the U.P. It bought for cost plus $1 per share commission to Kuhn, Loeb, and this would be the price to U.P. The U.P., moreover, as appears from its correspondence with Kuhn, Loeb, was not short of money for the reacquisition program.

Kuhn, Loeb, too, was in the buying program acting for U.P. and could be depended upon to turn over any Oregon shares it bought or held either at a nominal profit or on terms otherwise not onerous to the U.P.

(b) Lastly, it is sheer speculation to suggest that the U.P. might have been successful in its efforts to acquire only the Shore Line and not the Oregon Railroad and Navigation. The Oregon Short Line owned a dominating if not a controlling

block of stock in Oregon Navigation and there is nothing in the record to suggest that the U.P. would not be as successful as it soon was (findings 180, 414) in obtaining the Navigation preferred.

336. (a) (1) The defendant's expert testified that his opinion that the reacquisition was uncertain was based on the premise that the reorganization committee did not have control, and that in his valuation he had assumed the probability of reacquisition at something better than 50–50, that is, somewhat better than an even chance.

(2) He further testified that if the probability of reacquisition were raised to 75 percent, he would increase his valuation of the Union Pacific common from $22.50 to close to $30, an increase of 33 percent. Further, that while a 75 percent probability would for purposes of valuation be tantamount to a substantially 100 percent likelihood of reacquisition, if the probability of reacquisition were raised to 90 to 95 percent, he would add $2 more to his per share valuation, bringing it up to $32, an increase of 42.2 percent over his first valuation of $22.50.

(b) It is found that on the basis of the probability of reacquisition having been found to be one of substantial certainty, the probability is comparable to the 90 to 95 percent probability considered by defendant's expert and thus that the opinion of the defendant's expert, on the supposition of the finding made herein of substantial certainty, is that the value per share of the reorganization common is $32 per share, greater than the valuation of $31.76 for the same stock derived from the aggregate valuations by the Commissioner of Internal Revenue of the reorganization and post-reorganization stock (finding 189).

(b) *Stock Market Values*

(i) *The Common*

337. The holder of a share of old common, who was on payment of the $15 assessment to receive one share of old common plus 15/100ths of one share of new preferred (finding

208) received trust receipts, later replaced by certificates of deposit, for his old common deposited. Trading in the trust receipts began on the New York Stock Exchange on January 23, 1896. The monthly high and low prices and the number of these receipts sold as reported by the Commercial and Financial Chronicle for February 1896 through March 1898 were as shown below. The prices for August 26 through October 19, 1897, were for receipts on which $5 of the assessment had been paid; the prices for October 20 through November 23, 1897, were for receipts on which $10 of the assessment had been paid; and the prices for November 24, 1897, and subsequent dates were for receipts on which the full $15 assessment had been paid.

Month	High	Low	Number of receipts sold
1896:			
February	9	6¼	99,695
March	8⅝	6½	36,692
April	10	7⅞	154,947
May	7¼	----	23,954
June	8⅝	6½	29,784
July	7½	5¾	26,547
August	6½	4	20,057
September	7½	5	32,385
October	9¼	5½	76,122
November	9	12½	131,128
December	11⅛	8	80,390
1897:			
January	10	6¼	162,577
February	7⅝	6½	36,715
March	7½	5½	23,181
April	6½	4½	15,713
May	7⅜	5⅜	44,029
June	8	5⅝	72,860
July	8¼	5⅞	68,418
August	18¼	7¾	319,786
September	24⅞	16¾	611,346
October	27¾	20¼	508,547
November	24½	18¾	152,366
December	26½	23⅛	130,445
1898: [1]			
January	35¼	25⅛	530,042
February	36½	26¾	377,436
March	31⅜	23	91,018

[1] Daily figures given in the following finding.

338. For the period beginning January 3 through March 4, 1898, the daily high, low, and average (for the days after February 1) price of the trust receipts sold on the New York Stock Exchange and the number of receipts sold for each week were as follows:

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Date In 1898	High	Low	Average	Number of receipts sold during the week
Jan. 3	25¾	25½		
4	25¾	25½		
5	26¼	25¾		
6	27¾	26⅝		
7	29	28		59,389
8	29	28½		
10	28¾	28¼		
11	29⅞	28¼		
12	31¾	30		
13	31	30		
14	32⅜	31⅛		148,349
15	31⅛	30		
17	31⅞	30⅞		
18	31⅞	30⅝		
19	32¼	30¾		
20	32¼	31⅜		
21	31⅞	31¼		130,850
22	31½	31¼		
24	31½	30		
25	32	30¾		
26	33¼	32⅛		
27	33⅜	33⅛		
28	34⅛	33½		140,537
29	34⅝	33⅞		
31	35¼	34½		
Feb. 1	36½	35⅛		
2	36½	35½	36	
3	35⅝	35	35.3	
4	35½	34¼	34.7	176,603
5	35¼	34⅝	34.9	
7	34¼	33½	33.9	
8	34⅛	32⅝	33.4	
9	34¼	33¼	33.8	
10	34½	33¾	34	
11	34½	33¾	34.1	87,071
14	34⅞	33⅝	34.3	
15	34½	34	34.3	
16	33⅞	32	32.9	
17	33½	32⅞	33.2	
18	33½	32⅞	33.2	71,542
19	32⅝	31⅜	31.8	
21	31¾	30	30.9	
23	31½	29¼	30.2	
24	29¼	28¾	28	
25	30½	28¾	29.6	71,812
26	30½	30¼	30.4	
28	30½	29¾	30.1	
Mar. 1	31⅜	30½	30.9	
2	31⅜	30	30.7	
3	30½	29⅝	30.1	
4	30¼	28¾	29.5	49,748

339. In order to obtain the cash necessary for payment of the Union Pacific debt to the Government, the reorganization committee sold purchase money certificates to two syndicates. Each certificate had a face value of $1,000 and was exchangeable for $1,000 of new Union Pacific 4 percent bonds and $500 par value of the new Union Pacific preferred stock. The holder of a certificate was entitled to interest at the rate of 4 percent. For each certificate, the committee received $1,000 in cash.

340. For the period beginning on December 4, 1897, and ending on February 7, 1898, the purchase money certificates were traded on the New York Stock Exchange. The number of certificates sold and the high and low prices stated as a percentage of $1,000 were as follows:

Date	High	Low	Number of receipts sold
Dec. 4, 1897	110½	110½	48
Dec. 6, 1897	111¼	110⅝	66
Dec. 7, 1897	111¼	111	151
Dec. 8, 1897	111¼	111¼	100
Dec. 9, 1897	111¼	111	74
Dec. 10, 1897	110	110	20
Dec. 11, 1897			none
Dec. 13, 1897	110½	110	16
Dec. 14, 1897	111	110⅝	35
Dec. 15, 1897	111	110⅝	121
Dec. 16, 1897	111⅜	110⅞	108
Dec. 17, 1897	111	110⅞	50
Dec. 18, 1897	111	111	75
Dec. 20, 1897	112	111¼	4
Dec. 21, 1897	111⅜	111⅛	5
Dec. 22, 1897	112	111⅜	245
Dec. 23, 1897	111¾	111½	93
Dec. 24, 1897	111¾	111⅜	55
Dec. 27, 1897	111⅝	111⅜	25
Dec. 28, 1897	111½	111¼	76
Dec. 29, 1897	112	111¾	79
Dec. 30, 1897	112¼	111¾	229
Dec. 31, 1897	112¼	112	86
Jan. 3, 1898	112⅜	111⅞	135
Jan. 4, 1898	112¼	112	128
Jan. 5, 1898	112½	112¼	88
Jan. 6, 1898	113⅛	112⅜	684
Jan. 7, 1898	113⅜	114⅛	565
Jan. 8, 1898	115⅜	115½	129
Jan. 10, 1898	116⅛	115⅜	265
Jan. 11, 1898	117	116½	698
Jan. 12, 1898	118⅛	117¼	744
Jan. 13, 1898	119⅜	118⅜	468
Jan. 14, 1898	120⅜	119⅜	644
Jan. 15, 1898	120¾	119¼	190
Jan. 17, 1898	119¾	119	419
Jan. 18, 1898	119⅜	119	468
Jan. 19, 1898	120	119⅛	410
Jan. 20, 1898	120¼	119⅜	227
Jan. 21, 1898	120	119⅛	167
Jan. 22, 1898	120	119⅛	197
Jan. 24, 1898	119⅞	119⅛	123
Jan. 25, 1898	120	119½	343
Jan. 26, 1898	120¼	120	563
Jan. 27, 1898	120⅜	120¼	572
Jan. 28, 1898	121⅞	120¼	755
Jan. 29, 1898	123⅛	122	338
Jan. 31, 1898	124¼	123¾	303
Feb. 1, 1898	126⅛	125	149
Feb. 2, 1898	126⅜	126	378
Feb. 3, 1898	126⅜	126	240
Feb. 4, 1898	126	126	85
Feb. 5, 1898	126¼	126	40
Feb. 7, 1898	126	126	13

341. Plaintiff's common stock was first traded on the New York Stock Exchange on February 25, 1898. For the period beginning February 25 and ending March 7, 1898, the daily

high and low price and the number of shares sold were as follows:

Date in 1898	High	Low	Average	Number of shares sold
February 25	22⅛	21	21¾	1,600
February 26	22½	22¼	22⅜	400
February 28	22⅛	22¼	22⅛	100
March 1	22½	22¼	22⅜	400
March 2				none
March 3	22½	22¼	22⅜	350
March 4	22	20¾	21⅜	4,600
March 5				none
March 7	18½	17¾	17⅛	1,610

342. The monthly high and low prices (with fractions rounded off to the nearest dollar) of Union Pacific Railroad Company common stock for the years 1898–1901 were as follows:

	High	Low	Average	No. traded
1898:				
January				
February	23	21	22	2,100
March	23	16	19½	43,771
April	21	18	19½	37,997
May	24	20	22	93,395
June	26	23	24½	87,470
July	25	23	24	23,682
August	35	24	29½	293,379
September	34	29	31½	289,954
October	33	32	32½	128,897
November	40	31	35½	255,425
December	44	37	40½	426,226
1899:				
January	50	42	46	560,041
February	50	45	47½	372,480
March	50	44	47	328,886
April	49	45	47	184,226
May	47	41	44	195,830
June	43	38	40½	167,305
July	46	42	44	136,505
August	48	43	45½	291,969
September	48	43	45½	212,516
October	48	42	45	275,742
November	51	47	49	492,596
December	52	40	46	771,009
1900:				
January	49	44	46½	361,860
February	51	47	49	532,711
March	59	48	53½	656,629
April	61	56	58½	821,485
May	57	52	54½	396,910
June	57	48	52½	290,479
July	59	50	54½	585,232
August	61	58	59½	322,672
September	58	54	56	283,169
October	63	57	60	774,542
November	75	61	68	1,007,893
December	81	71	76	839,946
1901:				
January	88	78	83	1,709,690
February	98	85	91½	1,598,305
March	95	86	90½	871,714
April	120	90	105	3,140,980
May	133	76	104½	4,427,275
June	116	105	110½	1,813,860
July	111	90	100½	----------
August	105	93	99	----------
September	102	93	97½	----------
October	103	94	98½	----------
November	109	100	104½	----------
December	104	97	100½	----------

Testimony and other findings are sometimes based on figures not rounded off and may thus vary slightly from the foregoing figures.

343. The annual high and low prices of Union Pacific common stock for the years 1898–1915 were as follows:

	High	Low	Average
1898	44¾	16⅛	30¼
1899	51½	38½	44 13/16
1900	81⅝	44⅝	62⅛
1901	133	76	104½
1902	113¼	93¼	103⅛
1903	104⅝	65¾	85 9/16
1904	117	71	94
1905	151¾	113	132⅜
1906	195⅜	138½	166 13/16
1907	183	100	141½
1908	184⅞	110½	147 11/16
1909	219	172⅝	195¾
1910	204¼	152¼	178½
1911	192⅜	153½	172 15/16
1912	176¾	150¾	163¾
1913	162⅜	137¾	150¼
1914	164⅜	112	138 3/16
1915	141½	116¾	128⅝

(ii) *The Preferred*

344. The daily high, low, and average prices for plaintiff's preferred sold on the New York Stock Exchange and the number of shares sold for each week for the period beginning February 2, 1898, and ending March 4, 1898, were as follows:

Date in 1898	High	Low	Average	Number of shares sold during the week
Feb. 2	63¾	61⅝	62.5	
3	62⅝	61½	62.1	
4	61⅞	60¾	61.3	122,644
5	62⅝	61¾	62.2	
7	62⅜	61	61.7	
8	62	60⅛	61.3	
9	62	61	61.5	
10	62¼	61⅛	61.9	
11	62½	61	61.6	146,805
14	62⅛	60⅛	61.3	
15	61⅞	61⅛	61.5	
16	61½	59	60.1	
17	60⅝	59¼	59.8	
18	60⅜	59½	59.9	133,253
19	59¼	58½	58.9	
21	57½	55½	56.3	
23	57⅜	54½	55.9	
24	53⅞	51	52.4	
25	55	52¾	53.9	167,098
26	54¼	53⅞	54.3	
28	55⅝	53½	54.6	
Mar. 1	57	55⅝	56.3	
2	56¾	55	55.9	
3	55¼	55	55.4	
4	55½	52¾	54.1	123,722

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345. The monthly high, low, and average prices of Union Pacific preferred for the first six months of 1898 were as follows:

1898	High	Low	Average	No. traded
January				
February	63	51	57	603,251
March	57	46	51.5	674,941
April	54	49	51.5	521,146
May	60	54	57	603,466
June	63	58	60.5	484,925

346. The yearly high, low and average prices of Union Pacific 4 percent preferred stock for the years 1898–1915 (with fractions rounded off in the first 4 years) were as follows:

Year	High	Low	Average
1898	74	46	60
1899	85	66	75½
1900	85	71	78
1901	100	82	91
1902	95	86⅝	90 1¾6
1903	95¼	83½	89⅜
1904	98	86½	92¼
1905	101⅝	95½	98 9/16
1906	99¼	91½	95⅜
1907	96	75	85½
1908	98	79¼	88⅝
1909	118½	94	106¼
1910	103⅜	88¼	96
1911	96	89	92½
1912	96½	88¼	92⅜
1913	93½	79¾	86⅝
1914	86	77½	81¾
1915	84⅛	79	81 1/16

347. The average prices paid for the stock in sales in the indicated periods on the New York Stock Exchange, compared with the valuations by defendant's expert, are as follows:

Shares	Valuation dates	Market price range	Time period of price range	Average of market high and low in time period	Valuations by defendant's expert
Reorganization Stock:					
610,000 common	Jan. 31, 1898	$25.875 26-16	On Jan. 31, 1898 (fdg. 388) Feb. to June, 1898.	$21	$22.50
750,000 preferred	Jan. 31, 1898	62.50 63-46	On Feb. 2, 1898 (fdg. 382) Feb. to June, 1898.	54.50	45
Post-Reorganization Stock:					
137,301 common	Jan. 26, 1899 to Feb. 25, 1899	50-42	Jan. to Feb. 1899	46	35
68,650 common	Feb. 26, 1899 to Mar. 4, 1899	50-44	Feb. to Mar. 1899	47	35.25
27,460 common	Mar. 5, 1899 to Mar. 11, 1899	50-44	Mar. 1899	47	35.375
31,642 common	Mar. 12, 1899 to June 30, 1899	50-38	Mar. to June 1899	44	38
1,966 common	July 1, 1899 to Dec. 1, 1899	52-40	June to Dec. 1899	46	43.75
3,688 common	Dec. 2, 1899 to June 30, 1900	61-40	Dec. 1899 to June 1900	50.50	72
2,636 common	July 1, 1900 to June 30, 1901	133-50	July 1900 to June 1901	91.50	112

(iii) *Value Based on Stock Market Prices*

348. The defendant's expert testified that

Consideration has been given, in the valuation of the reorganization stock, to the market prices of Union Pacific securities—to the extent they are available—at the time of reorganization, immediately prior thereto, and shortly thereafter.

349. In 1896, during the reorganization, the common stock of the old U.P. had sold for as low as 3½. In April 1897, less than a year before consummation of the reorganization plan, it sold as low as 4½. From there on, it showed an upward trend as the date drew closer for transferring the assets from the receivers to the new company.

The improved prices of course reflected to a degree the payment of the assessment of $15 per share in three installments of $5 each in September, October and November 1897, although the degree of price rise as reorganization neared was greater than the cash payment.

350. The trust receipts for the predecessor's common stock deposited with the reorganization committee, with all assessments paid, entitled holders to one share of plaintiff's common plus $15 of par value in new $100 par value preferred stock. The trust receipts sold at a high of $24⅛ in November, $26½ in December, and shortly before the new company came into being at midnight, January 31, 1898, they attained a peak of $35¼.

351. The derived market prices of a share of U.P. common on January 31, 1898, based upon that day's high trust receipt price, was $25.875 or $25⅞.

The derivation is obtained as follows: Since a trust receipt equalled 1 share of common plus 15 percent of 1 share of preferred, the value of 15 percent of a share of preferred was $9.375, obtained by multiplying $62.50, the mean price of a share of preferred on February 2, 1898, the first day the shares were traded, by 15 percent. Deducting $9.375 from the $35.25 price of a trust receipt (the high) at midnight January 31, 1898, leaves $25.875 or 25⅞ as the derived price of a share of common stock on January 31, 1898, based on the price of the preferred on February 2, 1898, the first day they were traded. See findings 145, 148–150.

352. When the new shares were first traded on the New York Stock Exchange on February 25, 1898, U.P. common sold at a high of $22.50 and a low of $21. The price fell to $16⅛ in March.

353. At the indicated high of about $25⅞ at about the time of reorganization, the market value of the 610,000 shares of the new U.P. common stock outstanding or to be outstanding was approximately $15.8 million. At the low of $16⅛ in March, the market valuation was slightly over $9.8 million.

354. The range of the new preferred stock on February 2, 1898, the first day it was traded, was 63⅜—61⅝, or an average of 62½. In the following month, it fell back to 45⅞. The high of around 63 was duplicated in June and was decisively surpassed in August when a price of 67½ was attained.

355. (a) The defendant's expert testified that

Considering that the stock was noncumulative and a nondividend payer, the market's evaluation of the stock was liberal. It was, however, an era of low money rates, and the possibility of initiation of dividends before too long in the light of growing earnings undoubtedly was a potent market influence.

(b) It is found that the foreseeability of growing earnings from a reconstituted U.P. free of Government restrictions, in an era of rising national prosperity, made the market evaluation not a "liberal" index of its value. The dip in market price soon after February was a natural reaction from the opening, and was not a consequence of substantive negative factors.

356. At the high of 63⅜ established on the first day of trading, the market was placing a value of $47.5 million on the 750,000 shares of the new preferred, while at the low of 45⅞ in the following month, the market value of the issue was about $34.4 million. Higher valuation, both at high and low, would follow from the use of the August high of 67½ or the first day low of 61⅝.

357. The 4 percent bonds of the new company opened at 92 on February 1, 1898, which would give the issue a market valuation of $82.8 million.

The high for February was 95⅞ and the low was 92. Three months later, in May, the high and low were 94½ and 91¾, though in the interim they were as high as 95⅞, at which level the market value was nearly $86.3 million.

358. Adding up the mentioned market valuations of the new securities of the U.P. at highs and lows around the time of the reorganization, as noted in findings 353–354, produces the following tabulation:

First Mortgage & Land Grant 4s 1947	$86,300,000	$82,800,000
4 percent Preferred Stock (noncumulative)	47,500,000	34,400,000
Common Stock	15,780,000	9,800,000
Totals	149,580,000	127,000,000

The foregoing market aggregate values give a range of $127–149.6 million, with a mean of about $138.3 million.

359. (a) The defendant's expert testified

That the market value of U.P.'s securities in later years—even less than a year after the reorganization—turned out to be substantially greater than around the time of the reorganization hardly appears to have much, if any, bearing on the valuation of the railroad when it emerged from the protection of the courts. Changed conditions that could not have been foreseen had a great deal to do with the later prosperity of the Union Pacific, and Mr. Harriman's daring, but successful, speculations based on U.P.'s credit, also contributed heavily to the improved market prices. Those closely connected with the U.P.—ranging from receivers to the members of the first board of directors of the reorganized road (with Mr. Harriman probably the only exception on the latter)—saw no basis for any great optimism, let alone prosperity.

(b) The foregoing testimony and conclusion is not accepted.

(1) It is found that Harriman was not alone in seeing a basis for optimism. His board approved his programs, among them his very early program for large expenditures in physical plant (see finding 307).

(2) The steady rise in market prices reflected enhancements in value not so unforeseeable as defendant's expert testified. The upturn dated from 1896 and Harriman cor-

rectly judged the improving business conditions. The prospects for profits and the enhancements in value soon to come after January 1898 could be appreciated at that time by a reasonably informed investor, although the extent of the coming prosperity could of course not be known. See findings 300 et seq. The inability of those "closely connected" with the U.P. to see the coming prosperity, mentioned by the witness, dates from earlier, depression and receivership times.

360. (a) The defendant's expert testified that

It must be acknowledged that inasmuch as the U.P. had just emerged from receivership and that its new preferred and common stock were nondividend payers, a great element of speculation existed in the stocks. For this reason, it may be concluded that even the low part of the range of $127 million, in the market aggregate valuation set out in finding 358, was not an unduly and severely depressed one.

(b) The foregoing testimony and conclusion is not accepted. It is found that

1. The recency of the reorganization and the fact that the new stock paid no dividends do not establish that the stocks had a great element of speculation, or that the low of the market was a correct value or a "not unduly and severely depressed" value. These factors alone might tend, if prospects were good, as much or more to bring about a substantial undervaluation. In other words, a company just out of reorganization and not paying dividends may be an exceedingly good investment at a market-undervalued price, if it has prospects.

The nondividend paying quality of the stock was in the past. From the very fact of the nature of the reorganization and where the company was left at its end, these were stocks whose past was past. The road had reasonably hopeful prospects for the future; this is the subject of other findings. The stocks did not have a great element of speculation. They were rather superior investments.

2. The "low part of the range of $127,000,000" was in fact "an unduly and severely depressed one," if only because it may well have been based on the recency of reorganization and the lack of present dividends, instead of the great potential for

profit that a unique transcontinental system built on the U.P. could become.

The market lows which added together produced the $127 million are the low of 16⅛ for the common and 45⅞ or 46 for the preferred, all in March 1898. These are low points in the second month of trading, in a year in which the monthly averages, except for the falter in March, rose steadily. For preferred the monthly average prices rose in the whole year from 57 to 72, with a dip to 52 only in March and April. The highs rose from 63 to 74, and the lows from 51 to 69. For the common, the average monthly prices rose in the whole year from 22 to 40.5, with a dip to 19.5 in March and April. Highs rose from 23 to 44 and lows from 21 to 37. This first half of 1898 was a time of increases in earnings, of physical renewal of the road, of acquisitions of other railroads.

The drops in market price in about March are properly to be regarded not as reflective of enduring value but rather as hesitations or reactions from the strong opening in January and February. They were preceded and succeeded by prices more reflective of investor's confidence in the fundamental profitability of the road. Because it was to such a degree foreseeable that the upward trend of business profitability would continue and that the U.P. system would be substantially reconstituted and have good and increasing earnings, it is concluded that the low part of the range of $127 million under discussion was in fact an unduly and severely depressed market valuation.

(c) *Net Asset Values*

361. The cost of constructing the Union Pacific, Kansas Pacific, and the Denver Pacific was approximately $82 million, as follows:

	Approximate cost of construction
Union Pacific	$54,200,000
Kansas Pacific	22,651,000
Denver Pacific	5,000,000
Total	81,851,000

To the foregoing total of $81,851,000 should be added additions and betterments to the original construction. From

1867 through 1886, capital expenditures on the Union Pacific amounted to $13,765,244.97. In the years 1887–1893, inclusive, expenditures of a similar nature on the Union Pacific (exclusive of branches) amounted to $3,472,602, exclusive of betterments of $1,046,739 charged to operating expense during the period. If the foregoing combined total of $17,237,847 of additions and betterments is added to the above estimated original cost of $81,851,000, the total property investment would be $99,088,847. Capital expenditures during receivership were presumably small. See finding 307.

362. (a) The defendant's expert testified that

What was actually paid by the reorganization committee for the road in terms of (1) new first mortgage bonds issued to old bondholders and (2) cash for the discharge of legitimate longstanding obligations is of course a reflection of the minimum payments essential to acquisition, free of old debts, of the net assets before the reorganization committee.

Total payments of the type covered under (1) and (2), above, amounted to $94,441,535, as follows:

New first mortgage bonds issued to holders of old bonds	$30,928,960
Net amount of cash paid to the United States Government	54,487,768
Cash paid to nonassenting bondholders	7,753,000
Net amount of cash paid for securities of old collateral trust notes	1,271,807
Total cash and bonds paid	94,441,535

What was given to holders of the old bonds in the form of new preferred stock can be regarded as a bonus to induce them to agree to the plan (see finding 288); likewise, payments made in connection with the reorganization proceedings in cash and securities can be dismissed as not an addition to value, but rather disbursements necessitated by the problems created by earlier inept management. This latter may not have been entirely correct, and there may have been a few millions more in value, since the nature of some of the disbursements made by the reorganization committee is not entirely clear from the records available and there are some discrepancies in these records.

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These distributions and disbursements indicate that the net assets of the Union Pacific were worth $95–100 million, plus the value of the land grant property (land contracts and unsold lands) and various miscellaneous assets. The land grant assets had a value of about $15 million around the time of the reorganization, and the other miscellaneous assets were worth $5–10 million. This would bring the total net asset value up to around $115–125 million.

(b) The foregoing testimony and conclusion are rejected as substantially incomplete and misleading. The list of payments omits items such as the large amounts indirectly utilized in satisfying the Government debt and the stock issued to persuade holders of soon-to-mature bonds to accept an almost 50-year postponement of maturity and a reduction in interest rate (finding 287). The testimony wrongly depreciates and fails to value the indispensable work and contributions to value of the reorganization committee and the Purchase Money Syndicates, not to speak of the reorganization itself.

363. In the testimony given to the United States Pacific Railway Commission in 1887 and the Senate Committee on Pacific Railways in 1896, the valuations placed on the property of the Union Pacific Railway were consistently well below $100 million. The only exception is the valuation of around $116–120 million which can be derived from the testimony in 1896 of Mr. Winslow S. Pierce, counsel for the reorganization committee, regarding the value of the railroad as security for the 4 percent first mortgage bonds to be issued in the reorganization. This valuation is the sum of the following items:

1,477 miles bond-aided, at $50,000 per mile	$73, 850, 000
350 non-aided miles of U.P., plus 270 miles of branches	18, 000, 000
Omaha bridge and terminals at Kansas City and Denver	6–9, 000, 000
Land and land contracts	19, 000, 000
Total	116–119, 850, 000

The foregoing valuations given in 1887 and 1896 (other than that based on Mr. Pierce's views) probably were tinged

with a great deal of pessimism, skepticism, and even belligerence toward the U.P. The value worked out on the basis of Mr. Pierce's testimony very likely could be regarded as the optimistic approach, since as counsel for the reorganization committee he had no reason to denigrate the position of the securities holders by understating the value of the security for the new bonds.

364. The defendant's expert testified that as to what weight should be placed on the price paid by the reorganization committee, the position could be taken that the committee finally paid to the United States Government much more than it considered a reasonable settlement simply to have done with the whole matter and restore the road to the securities holders. The other side of the coin is that the committee may simply have been bluffing—playing a good game of poker, so to speak—in its dealings with the Government, the road's biggest creditor. Some basis for this view certainly appears to lie in the availability of much more money than was actually required to consummate the reorganization. The summary of the committee's receipts and disbursements in the period October 15, 1895, to May 16, 1898, shows that $10,605,000 was returned to the reorganization syndicate and another $9,050,000 in advances also was repaid in cash, presumably representing unneeded funds.

365. (a) The defendant's expert testified that

The value of the net physical assets of the U.P. (including the Kansas Pacific) on January 31, 1898, the time of the reorganization, was $115–120 million. This total includes the lands, land contracts, and miscellaneous assets. If the net debt of $90 million as of January 31, 1898, is deducted from the $115–120 million net asset value, there is a balance of only $25–30 million for the $75 million of preferred stock or only about $33 to $40 per share and nothing for the common.

(b) It is found that net asset value as computed in the foregoing is to be distinguished from value based on prospects for earnings and appreciation and has little materiality to the fair market value of the stock in issue. Net asset value is the value of the lifeless assets, after a depression and a reorganization. Yet the road was the core of a great trans-

continental system, which though it had gone through lean years was now free to engage in profitable business.

In sum, the total net asset value as computed by defendant's expert is (a) based at least in part on an incomplete estimate of the "price" paid on reorganization; (b) not material by definition, in that it is based on tangible assets and omits such important considerations as earnings and prospective earnings; (c) belied by stock market values (see finding 247 et seq.) and the judgment of the holders of 610,000 shares of common who paid $15 per share to save their investment; (d) incomplete in omitting any consideration of branches and subsidiaries and the prospects for reacquisition and (e) insofar as it concludes there was "nothing for the common" is contradicted by the final opinion of the defendant's expert himself, who gave a value of $22.50 per share to the common.

(d) *Values Based on Capitalization of Earnings*

366. The operating earnings for the years 1889 through 1897 of that part of the old U.P. system acquired by plaintiff in the reorganization were as follows:

Year	Gross earnings	Operating expenses (including taxes)	Net earnings
1889	$19,775,556	$11,488,816	$8,286,680
1890	20,438,208	13,163,449	7,274,759
1891	19,687,738	11,841,286	7,846,452
1892	20,361,402	11,811,134	8,550,268
1893	17,376,792	11,172,075	6,204,717
1894	14,817,807	10,502,730	4,315,077
1895	14,336,291	9,434,134	4,902,157
1896	14,382,291	9,641,820	4,740,471
1897	16,444,892	10,842,379	5,602,513
Nine year average: 1889–97	17,513,443	11,099,758	6,413,677
Five year average: 1893–97	15,471,615	10,318,628	5,152,987

As already indicated, the foregoing are not system earnings, but only those generated by the 1,822 miles owned by the predecessor U.P. and acquired by plaintiff in the reorganization. For most of the years 1889–1897 the U.P. system included other, branch and subsidiary roads, and thus included a much larger number of miles than 1,822.

367. During the entire nine years which are the subject of the preceding finding, the average track mileage operated

was substantially unchanged. It was 1,821.37 in 1889 and a fraction over 1,822 miles in each of the last five years of the period. For the nine year span, total net earnings from operations, after taxes, amounted to $57,723,094, or an average of $6,413,677 per year, while for the five year period total net earnings were $25,764,935, or an average of $5,152,987 per year. If the foregoing averages are capitalized at 5, 6 and 7 percent, they would produce the following schedule of valuations, compared with the corresponding figures for 1897 alone:

Capitalization rate	Average annual earnings of $6,413,677 for 9 yrs. 1889–97	Average annual earnings of $5,152,987 for 5 yrs. 1893–97	Earnings of $5,602,513 for the year 1897
5 percent	$128,273,544	$103,059,744	$112,050,260
6 percent	106,894,620	85,883,120	93,375,216
7 percent	91,623,960	73,614,103	80,035,900

368. (a) The defendant's expert testified that

Since the earnings of a single year can hardly be given great weight, consideration must be given to the record for the period 1889–1897 along with averages for this span of nine years and the most recent five years, which are the subject of the preceding finding.

The use of a 5 percent rate of capitalization is not warranted because of the generally poor status of the U.P. at the time and its far from clear future. As of January 31, 1898, the U.P. had an unsavory history, unfavorable ton-mile rates, poor physical condition, and lots of competition.

The speculative elements of the enterprise may even have warranted acceptance of a 7 percent rate. However, this is too extreme, so the 6 percent figures of about $93 million for 1897, $86 million for the five years 1893–1897, and $107 million for the nine years 1889–1897 are regarded as the most acceptable. A straight average of these three figures—which has a tendency to give weight to recency of trends—produces a figure of $95 million, which is adopted as the earnings valuation of the Union Pacific.

The various earnings valuations referred to in the foregoing paragraph are based on operating earnings alone. They do not give any consideration to the value of the land grants and miscellaneous other assets. If these are taken to be worth

(as previously mentioned in finding 362) around $15 million and $5–10 million, respectively, a total of $20–25 million should be added to the earnings valuation of $95 million to produce a January 31, 1898 value of $115 to $120 million predicated on operating earnings and the other stated assets or in the same range as the valuation for total physical assets in finding 365.

(b) It is found that the foregoing valuation, based on capitalization of earnings, and, what is more, past earnings in a depression, in reorganization, with a great debt hanging over the road, is immaterial to the valuation of the stock in issue. Defendant's expert himself seems to be of the same opinion, having based his valuation of the stock on earnings foreseeable, as of 1898, by him.

The valuation by defendant's witness suffers, too, from an exaggerated criticism of the U.P. as having an unsavory history and from a failure to recognize the imminence of the reconstitution of the U.P. system (encompassing, so to speak, an error as to prospects and an error as to retrospective matters, that is, an overabsorption in the past earnings of the U.P. in reorganization, without its branches and subsidiaries).

369. (a) The defendant's expert testified that

At any point in time, it may be possible to predict earnings for the next six months. The farther out in time one goes, the more uncertain the situation becomes. The plaintiff was an agricultural railroad, and its earnings were related to the agricultural situation and, more specifically, crop prices in the United States and Europe. It is very often difficult to determine the crop situation for the current year, and no one can be sure what the crops are going to be in any future year.

To this effect is the following comment in the Chronicle for June 25, 1898:

> The course of the wheat market is being very closely watched in view of its bearing on the prosperity of the farming classes and also on the outlooks for the Western roads in the immediate future. The sudden great change in the price of the cereal has taken many by surprise, and there is a disposition to think that it materially alters prospects in the West.

The close relationship between earnings and the crop situation is also confirmed by the following comment in the Union Pacific report to stockholders for fiscal 1901:

> The operating results obtained during the year, as shown above, clearly indicate that the continued prosperity of the territory served by your lines is most encouraging for the future of your properties. The lack of rain in Kansas and Nebraska affected the corn crop unfavorably; but, while the tonnage usually derived from that source will doubtless be reduced, it is expected that the excellent wheat crop and the expansion of general business will prevent diminution of the Company's income.

As of January 31, 1898, one could not have foreseen what plaintiff's earnings were going to be for fiscal 1899 or the following years.

(b) It is found that while it is difficult to forecast future earnings precisely, or to forecast earnings any long period ahead, the likelihood of increased and steadily increasing earnings for the U.P. was here to be foreseen from the favorable conditions existing. See findings 300–325.

(e) *Values Based on Price-Earnings Ratios*

370. On the basis of the net operating earnings for each of the years 1894 through 1897 shown in finding 366, assuming other income of $1 million, and deducting fixed charges of $3.6 million and preferred dividend requirements of $3 million, the U.P. had no earnings for its common stock for 1894 through 1896 and only about one-third of a cent per share of common for calendar 1897.

371. In the light of the foregoing finding, it is not feasible to compare Union Pacific common stock with other railroads on January 31, 1898, on the basis of past earnings.

372. The company's first annual report covered only the six months ended June 30, 1898. Not until late in 1899, when the fiscal 1899 report was issued, did the road furnish a record of its operating earnings for fiscal 1898. It did this in providing a comparison with results for fiscal 1899 to show what earnings would have been if the road had owned throughout the two-year period the lines acquired by June

30, 1899. On the assumption that other income and fixed charges in fiscal 1898 would have been the same as in fiscal 1899, earnings on the common stock for fiscal 1898 would have been $2.95 per share after full preferred dividend requirements.

373. (a) The defendant's expert testified that

It is possible, but rather improbable, that on January 31, 1898, one could have foreseen what Union Pacific's earnings would be in the fiscal year ended June 30, 1898.

The generally improved 1898 earnings figures for railroads would not be known for many months after January 31, 1898.

It is probably a fair conclusion that insiders and knowledgeable outsiders had a pretty good idea late in fiscal 1898 that Union Pacific's earnings for the year would be around $2.50 per share or better. But it is hard to believe this could have been anticipated as early as January 31, despite a general improvement in railroad earnings in the six or seven preceding months.

(b) It is found that knowledgeable investers as early as January 31, 1898, had a pretty good idea that U.P.'s earnings for fiscal 1898 would increase and might reach a figure in the neighborhood of $2.50 per share or better and certainly they knew that earnings would go upwards in view of the general improvement in railroad earnings in the half-year preceding, the generally available knowledge of U.P.'s affairs, presumably not kept from the financial and investing community interested in the emergence from reorganization of so important a railroad, and the prosperity of the country.

374. In any event, consideration was given by defendant's expert to price-earnings ratios on January 31, 1898, based on per share earnings in fiscal or calendar 1897 and in fiscal or calendar 1898.

375. A mean market price of $25.50 may be derived for Union Pacific common on January 31, 1898. The derivation is obtained by subtracting from the January 31, 1898 mean market price for the trust receipts of $34.875 (finding 338) the amount of $9.375, the indicated value of the $15 par value of preferred computed as follows: $62.50, the mean price

for the preferred on February 2, 1898, the first day traded (finding 344), times .15 or $9.375. When the stock was first quoted on the New York Stock Exchange on Friday, February 25, 1898, the range for the stock was 22½—21 and the volume of trading was 1,600 shares (finding 341). The February 25th range also proved to be the range for the month. The monthly price range for the remaining months of Union Pacific's 1898 fiscal year were as follows: March 23—16; April 21—18; May 24—20; June 26—23. The average of the high and low for the five months was 21⅜.

376. Such price-earnings ratios as in the preceding but one finding were computed for the common stocks of the following ten roads:

Atchison, Topeka & Santa Fe Railway Co. (AT&SF)
Chicago, Burlington & Quincy Railroad Co. (CBQ)
Chicago, Milwaukee & St. Paul Railway Co. (CMSTP)
Chicago & North Western Railway Co. (CNW)
Great Northern Railway Co. (GN)
Illinois Central Railroad Co. (IL)
New York Central & Hudson River Railroad Co. (NYC&HR)
Northern Pacific Railway Co. (NP)
Pennsylvania Railroad Co. (PRR)
Southern Pacific Co. (SP)

The stock of the Great Northern was in fact a preferred, but it was the only stock outstanding and therefore equivalent to a common.

377. Several of these roads had been regular dividend payers for years and therefore their stocks were to be regarded as well-established investments. In this category were the Chicago, Burlington and Quincy, the St. Paul, the North Western, the Great Northern, the Illinois Central, the New York Central, and the Pennsylvania. By contrast, the three other big roads, namely, the Santa Fe, Northern Pacific and Southern Pacific, occupied speculative positions. These railroads differed from each other in the sense that Southern Pacific had some earnings for its common stock throughout the depressed 1890's, the Northern Pacific demonstrated strong recuperative powers after its reorganization in 1896, and the Santa Fe was somewhat slower in recovery after its reorganization in 1895.

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378. It is clear that Union Pacific, in emerging from receivership in early 1898 after many lean years, was a good deal more like Northern Pacific and Southern Pacific than those with good records of earnings and dividends. It was therefore only to be expected that the investment grade issues providing regular dividends would command relatively good price-earnings ratios and that the nondividend-paying Union Pacific, Northern Pacific, and Southern Pacific would sell at lower multiples. Moreover, in the later 1890's, interest rates were low; good dividend-paying stocks were in especial favor and investors were inclined to pay premium price-earnings ratios for roads showing dividend stability.

379. The price-earnings ratios for the common stock of the Union Pacific and the aforementioned ten roads on January 31, 1898, based on per share earnings in fiscal or calendar 1897 and in fiscal or calendar 1898, are as follows:

	Mean price Jan. 31, 1898	Earnings per share on com. fiscal years ended June 30—		P/E ratio based on earnings for—	
		1897	1898	1897	1898
UP	[a] $25.5	Nil	[j] $2.95	----------	8.6
AT&SF	13.375	Nil	Nil	----------	----------
CBQ	100.6875	[g]	8.37	----------	12.0
CMSTP	96.25	[h] $6.10	[h] 9.06	15.8	10.6
CNW[a]	126.4375	[h] 7.00	[h] 9.51	18.1	13.3
GN[b]	139.25	9.83	23.29	14.2	6.0
IL	108.5625	5.33	8.60	20.4	12.6
NYC&HR	118.875	4.35	4.95	27.3	24.0
NP vtc[c]	28.1875	[i]	4.64	----------	6.1
PRR[d]	[f] 59.5	4.19	3.96	14.2	15.0
SP	20	2.38	4.88	8.4	4.1

[a] Fiscal years ended May 31.
[b] All figures related to preferred stock, the only class outstanding.
[c] vtc means voting trust certificates.
[d] Calendar year.
[e] Calculated by deducting 15 percent of mean value of 62½ for U.P. preferred stock on Feb. 2 (range 63$^{1}/_{8}$-61$^{5}/_{8}$), amounting to 9.375, from average value of trust receipts, all installments paid, on Jan. 31, 1898 (range 35$^{1}/_{4}$-34$^{1}/_{2}$), 34.875.
[f] Price equals one-half of mean on New York Stock Exchange, where quotations were in percentage of par value; the par value of Pennsylvania was $50.
[g] Reported for only six months ended June 30, 1897.
[h] Participating basis.
[i] Reported for only ten months ended June 30, 1897.
[j] Estimated on pro forma basis.

380. Accordingly, on known 1897 earnings, the price-earnings multiples ranged from 8.4 to 27.3 for the roads other than Union Pacific, Sante Fe, Chicago, Burlington and Quincy, and Northern Pacific. Union Pacific and Santa Fe had no earnings and the last two were excluded because their

reports did not cover a full twelve months. The higher ratios were for the dividend-paying issues, while the low ratio of 8.4 was for Southern Pacific.

381. On the generally improved 1898 figures most of the multiples came down considerably. Except for New York Central's 24.0, the dividend-paying issues had price-earnings ratios ranging from 6.0 to 15.0. Union Pacific's ratio—based on the $2.95 level mentioned in finding 379, and a price of $25.50—was 8.6, about half way between Chicago, Milwaukee and St. Paul's 10.6 and Great Northern's 6.0. The ratios of Northern Pacific and Southern Pacific—both nondividend payers, like the Union Pacific—were only 6.1 and 4.1, respectively.

382. (a) Defendant's expert testified that

From these figures, it is evident that U.P. common stock at $25.50 was far from being undervalued on the basis of earnings for 1898.

(b) The foregoing testimony is rejected. The data on price-earnings ratios is not probative on fair market value but shows only that U.P. common was selling at a certain multiple of the earnings figure employed, a ratio less than many but not all of certain other roads.

(f) *Comparison of Union Pacific Preferred With Other Stocks*

383. (a) The defendant's expert testified that

(1) Of the ten other railroads considered, only five had preferred stocks outstanding and that of Great Northern was preferred in name only. Of the four true preferreds in the group, those of the North Western and the St. Paul were investment grade issues, while that of the Santa Fe was a speculation. The preferred stock of Northern Pacific was definitely more comparable with Union Pacific preferred, but even it already possessed a distinctly better standing and had initiated regular dividends shortly before issuance of the Union Pacific preferred. Both Union Pacific and Northern Pacific were similar in being long haul light density railroads operating in the sparsely settled west and both had gone through a cycle of receivership and reorganization in

the 1890's. Northern Pacific had been reorganized in the fall of 1896 and issued a report covering only the ten months ended June 30, 1897. In this period, it earned only 65 cents per share on its preferred stock. However, as a spring wheat carrier, it benefitted strongly from the excellent crop harvested in the fall of 1897 and lost no time in inaugurating dividends on the preferred at the 4 percent regular rate provided in the charter. For the fiscal year ended June 30, 1898, Northern Pacific earned $8.95 per share on its preferred. Northern Pacific preferred stock sold in the 30's on the New York Stock Exchange virtually throughout the first six months of calendar 1897, when the earnings' outlook was drab. In June it started to move out of the 30's as the outlook for the spring wheat crop took form. In January 1898 it sold as high as 69 and on February 2, the date trading began in U.P.'s 4 percent preferred, it sold at a range of 68⅛–67⅜, or a mean of 67¾. At this price it provided a current return of 5.90 percent.

(2) By comparison with Northern Pacific preferred, U.P. preferred suffered. On the latter, earnings amounted to just $4 per share on a pro forma basis for the calendar year 1897, a period that closed only a month before issuance of the U.P. preferred. Since there appeared to be no reason to believe dividends would be initiated in the near future and it was too early to estimate earnings for the six months ended June 30, 1898, the U.P. preferred could hardly be considered as anything but a speculation. As such, it could not be regarded as much more than a common stock with something extra added because of its noncumulative claim to dividends of 4 percent per annum and its voting rights. Looked upon as a nondividend-paying common stock, the preferred would not have been worth more than six to ten times the pro forma earnings of $4 per share for 1897. The conclusion that as a nondividend-payer Union Pacific preferred was not worth more than six to ten times its 1897 pro forma earnings of $4 per share is also supported by the record of Santa Fe's noncumulative 5 percent preferred. In fiscal 1899, when Santa Fe earned close to $4 on its preferred ($3.67 to be exact), the stock reached a peak of 35½. Even in the three months following

the close of the fiscal year, it only sold as high as 37½ and was as low as 31⅜. Like Union Pacific preferred, Santa Fe preferred was a nondividend-payer at the time. Applying a multiple of six to ten to the pro forma earnings of $4 per share of plaintiff's preferred for calendar 1897 produces a price of $24 to $40 per share, or a mean of $32. Giving consideration to the possibility of dividend payments of up to $4 per share sometime in the future and the voting rights, a fair market value of $45 per share for plaintiff's preferred is warranted.

(3) As against the valuation of 45 assigned to Union Pacific preferred, the stock actually traded in a range of 63⅜–61⅝, with a mean of 62½, when it made its debut on the New York Stock Exchange on February 2, 1898. The high of 63⅜ on February 2 proved to be the peak for some time to come and before the short month of February had closed Union Pacific preferred sold as low as 51. In each of the following two months it sold below 50—as low as 45⅞ in March and 48⅞ in April.

(b) The foregoing testimony and conclusions are rejected.

(1) The witness' valuation of the preferred presumably assumes the same degree of probability of the U.P.'s reacquisition of the Oregon lines as underlies his valuation of the common. The preferred is as dependent on prospects of earnings, represented by the prospects of reacquisition of the Oregon, as is the common. The valuation by the witness of the preferred is thus as defective, in respect of the reacquisition of the Oregon, as is his valuation of the common.

(2) The valuation by the witness based on past earnings—for 1897—takes no or too little account of prospectve earnings, the beneficial effect of the reorganization and of increasing prosperity and likely prospective earnings. In short the valuation looks to the past and not the present and foreseeable future.

(3) The valuation is another expression of the witness' belief that earnings cannot be forecast even a few months before the end of a fiscal year; yet it appears from his recount of the affairs of the Northern Pacific that a favorable outlook in June for the harvest of a spring wheat crop was immedi-

ately taken by investors as evidence of a prospective rise in railroad earnings.

The professed inability to anticipate earnings to be formally reported in a few months is of special significance here.

The "pro forma" earnings of $4 per share are earnings for calendar year 1897, during reorganization. The same pro forma earnings for a preferred share for the fiscal year ending June 30, 1898 are $6.40. The sharp rise is doubtless in large part explained by the fact that the earnings of $6.40 were computed on the basis of lines owned as of June 30, 1898 and the earnings of $4 were computed on the basis of the U.P. as it stood during calendar year 1897, in receivership, without branches and subsidiaries. (And even the earnings of $6.40 do not consider earnings based on reacquisition of the Oregon lines, which came formally only in 1899.)

Clearly, then, had the witness anticipated even in part the earnings to be reported only 5 months following reorganization, the resulting valuation would be very different than the valuation he gave.

(4) While the preferred stock went to a low of 46 in March 1898, its highs were 63 when trading began in February, 57 in March, and then 54, 60 and 63 in April, May and June, and upwards thereafter. See findings 344–345. The witness seems to have chosen the low point, a point which should be regarded as a reaction, rather than an indication of enduring market value.

The Northern Pacific stock, the witness says, was selling in the 30's when earnings for the period ended June 30, 1897 were "drab"—65 cents per share—and it rose to 69 in January 1898 in anticipation of the June 1898 earnings of $8.95 per share. In the light of these facts, it is difficult to believe that investors were paying $60 for U.P. preferred in 1898, if the witness is correct in his opinion that dividends were not expected.

(5) It is difficult to credit the witness' opinion that dividends were not expected. The testimony is intrinsically contradictory and confusing and the conclusion is without support. First it is laid down that there appeared to be no reason to anticipate dividends "in the near future"; then a value of

$32, a mean from the product of a multiple of 6–10 as applied to $4 earnings, is raised to 45, partly as a result of "[g]iving consideration to the possibility of dividends up to $4 per share sometime in the future."

A pattern in which a derogation from value is followed by a contradictory recognition of value appears often in the testimony of the witness, with a possible appearance of objectivity. Another net impression, however, is that of an overstrong negative, first stated, designed to buttress an ungenerous positive statement of value.

11. *Conclusions on the Reorganization Stock*

384. The defendant's expert testified that

Use of the stock values of $22.50 for the common and $45 for the preferred (the witness' conclusions) plus a value of 92 percent for the bonds produces an aggregate value for plaintiff's assets of $130.3 million ($82.8 million for the bonds, $33.75 million for the preferred, and $13,725,000 for the common). This is within the range of $127–$149.6 million computed by the witness on stock prices (see findings 348–360) but exceeds the range of $115–120 million based on his valuation of the physical assets and his $95 million valuation based on a capitalization of earnings (see findings 359–365).

385. (a) Defendant's expert testified that

(1) The excess value of his valuations over the foregoing valuations is warranted by the fact that the holders of the predecessor's common thought it was worth putting up $15 per share to save their equity and the fact that, since the preferred was noncumulative, there was no danger of piling up accumulations and there was, on the other hand, the possibility of dividend payments on the common at about the same time the preferred might receive them. Other factors warranting these per share values for the reorganization stock were the control value of the preferred and common stocks (both possessed voting rights) and indications that the reorganized road soon would regain control of the Oregon Short Line and the Oregon Railroad and Navigation Company.

(2) The value of $22.50 per share for the common is based not so much on established earning power as on voting rights and potentials for the future. It is consistent with the market action of the stock within the five months following the reorganization, as described in finding 370. Finally, it is confirmed by the price-earnings ratios of the other railway common stocks of similar or better quality, as described in finding 379.

(3) The value of $45 per share for the preferred is warranted by the pro forma earnings of $4 per share for calendar 1897 and the market action of the stock in the first few months after its issuance, as described in finding 383. It is also justified by the comparison with the preferreds of Northern Pacific and Santa Fe, as described in finding 383.

(b) The foregoing testimony is rejected insofar as it purports to support the Government's valuations of the various issues of stock involved.

The testimony refers to a group of factors—control value, "potentials for the future," indications that the U.P. would "soon" reacquire the Oregon lines and so on—and advances the proposition that these factors warrant the excess of the aggregate valuation by the Government's expert of the stock involved over his several "valuations" based on net assets, past earnings, etc.

Valuations based on such standards as net assets and capitalization of past earnings are in the circumstances of the U.P. not legitimate starting points for a determination of fair market value, and thus it is no support for the conclusion of the Government's expert on fair market value that an "excess" has been added to such "valuations."

The evidence described in the prior findings has revealed the negative, valuation-depressing views of the Government's expert on the potentials for the future, on the probability that the U.P. would soon reacquire the Oregon lines and, indeed, on most or all of the elements bearing on fair market value. These views impeach the credibility of the witness' conclusion on fair market value, whatever the excess over his valuations by other standards such as net assets.

The evidence on the probability of the U.P.'s reacquisition of the Oregon has indicated an increase of his $22.50 valuation of the common to not less than $32, an increase of 42.2 percent. The same percentage increase of his $45 valuation of the preferred brings the value of the preferred up to not less than $64.

12. *Valuation of the Acquisition Stock*

(a) *The Exchange of U.P. Stock for Oregon Stock*

386. In January 1899, stockholders of the Union Pacific ratified a proposal to increase the common stock by 274,601 shares of $100 par value and to offer the new shares to stockholders of the Oregon Short Line on the basis of 1 share of U.P. common for 1 share of Oregon stock plus $3. The U.P. shares so issued to acquire the Oregon common, 273,493 in number, are herein called the post-reorganization stock.

387. There being no evidence to the contrary, Kuhn, Loeb presumably retained the 125,679 shares of Oregon Short Line bought from the U.P. in August 1898 (see finding 334) until the exchanges began on January 26, 1899 and then exchanged them.

388. Between January 26 and the end of March, most of the Short Line shares were exchanged; by June 30, 265,053 shares had been exchanged and as of that date the U.P. owned about 96½ percent of the Oregon Short Line stock and the Oregon in turn owned a majority of the common stock of the Oregon Railroad and Navigation Company, henceforth called Oregon Navigation.

Thereafter the relatively few remaining shares were exchanged or—as to a very few—acquired by the U.P., which eventually owned all the 273,507 Oregon common shares outstanding.

389. The 273,493 shares of acquisition stock were issued at the following times:

Period:	*Number of shares issued*
January 26, 1899 to February 25, 1899	137,301
February 26, 1899 to March 4, 1899	68,650

Period:	Number of shares issued
March 5, 1899 to March 11, 1899	27,460
March 12, 1899 to June 30, 1899	31,642
July 1, 1899 to December 1, 1899	1,966
December 2, 1899 to June 30, 1900	3,688
July 1, 1900 to June 30, 1901	2,636
July 1, 1901 to June 30, 1902	50
July 1, 1907 to June 30, 1908	100
Total	273,493

(b) *The Dollar Valuations by Defendant's Expert of the U.P. Acquisition Stock*

390. (a) The defendant's expert valued the 137,301 post-reorganization common shares issued in January–February, 1899 at $35 per share. He testified that in the succeeding months of 1899 the value of a common share rose by $1.25 per month. On this basis he valued the 267,019 shares issued between January 26 and December 1, 1899 as follows:

Issue Dates	No. of shares	Value per share
Jan. 26 to Feb. 25	137,301	$35
Feb. 26 to Mar. 4	68,650	35¼
Mar. 5 to Mar. 11	27,460	35⅜
Mar. 12 to June 30	31,642	38
July 1to D ec. 1	1,966	43¾
Total	267,019	

(b) He valued the 3,688 shares of common issued between December 2, 1899 and June 30, 1900 at $72 per share.

(c) He valued the 2,636 common shares issued between July 1, 1900 and June 30, 1901 at $112 per share.

(d) A recapitulation of these valuations, with aggregate valuations, is as follows:

Issue dates	No. of shares	Valuation per share	Aggregate valuation
Jan. 26, 1899 to Feb. 25, 1899	137,301	$35.00	$4,805,535.00
Feb. 26, 1899 to Mar. 4, 1899	68,650	35.25	2,419,912.50
Mar. 5, 1899 to Mar. 11, 1899	27,460	35.375	971,397.50
Mar. 12, 1899 to June 30, 1899	31,642	38.00	1,202,396.00
July 1, 1899 to Dec. 1, 1899	1,966	43.75	86,012.50
Dec. 2, 1899 to June 30, 1900	3,688	72.00	265,536.00
July 1, 1900 to June 30, 1901	2,636	112.00	295,232.00

(e) The foregoing valuations compared with contemporaneous market averages (finding 347) are as follows:

Issue dates	No. of shares	Valuation by defendant's expert	Average of market high-low prices
Jan. 26, 1899 to Feb. 25, 1899	137,301	33	46
Feb. 26, 1899 to Mar. 4, 1899	68,650	35¼	47
Mar. 5, 1899 to Mar. 11, 1899	27,460	35¾	47
Mar. 12, 1899 to June 30, 1899	31,642	38	44
July 1, 1899 to Dec. 1, 1899	1,906	43¼	46
Dec. 2, 1899 to June 30, 1900	3,688	72	50.50
July 1, 1900 to June 30, 1901	2,636	112	91.50

(f) The parties are agreed on a valuation of $175 per share for the 150 shares issued following June 30, 1901. There were 50 such shares issued between July 1, 1901 and June 30, 1902 and 100 such shares issued between July 1, 1907 and June 30, 1908.

(c) *Value of the Oregon Short Line at the Time of the Exchange Offer*

(i) *Value of the Oregon Itself*

391. At the time of the exchange offer, the market price for Oregon Short Line stock was in a good trend upwards ranging from 41 to 48. The stock had quadrupled since it sold at 11 in March 1897, when the line took over the properties of its predecessor. See finding 326. The rise had been a steady one, from 11 to 19 at the end of 1897, on to 40 at the end of 1898 and to 48 in January 1899, without display of serious weakness or violent price fluctuations. The favorable market behavior may have reflected both the rise in Oregon's earnings, to be detailed below, and confidence in its prospects, as well as anticipation of the prospective exchange offer, coupled with confidence in the prospects of the U.P. The U.P.'s intention to reacquire its branches and subsidiaries was well-known, the program of buying Oregon stock on its behalf was very likely known to investors, and some form of exchange was doubtless anticipated substantially in advance.

392. The monthly high and low prices of Oregon Short Line common stock as reported by the Commercial & Financial Chronicle for the years 1897, 1898 and for the first 3 months of 1899 (fractions rounded off to the nearest dollar) were as follows:

1

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Month	Prices of common stock			Number of shares traded
	High	Low	Average	
1897:				
March	13	11	12	----------
April	11	11	11	----------
May	12	11	11½	----------
June	18	12	15	----------
July	21	18	19½	----------
August	24	19	21½	----------
September	23	20	21½	----------
October	22	18	20	----------
November	19	18	18½	----------
December	20	18	19	----------
1898:				
January	25	19	22	----------
February	31	25	28	31,224
March	32	27	29½	5,817
April	30	27	28½	800
May	32	30	31	1,428
June	34	29	31½	1,512
July	31	28	29½	808
August	38	31	34½	8,915
September	37	30	33⅓	3,792
October	30	26	28	1,507
November	37	28	32½	5,854
December	43	37	40	4,756
1899:				
January	48(Jan. 23)	42(Jan. 5)	45	6,471
February	41	41	41	245
March	42	42	42	178

The foregoing are stipulated figures. In apparent contradiction of the figures for February and March 1899, it is also stipulated that during February and March 1899 the stock sold at a high of 44.

393. At the time of the exchange offer, revenues and earnings of the Oregon Short Line were on a sharp trend upwards.

394. (a) The defendant's expert in his testimony implied that the marked uptrend began in fiscal 1899, having been stimulated by the Spanish-American War and the acquisitions of the Philippine Islands and the Hawaiian Islands, which significantly increased traffic to the West Coast.

(b) It is found that the trend upwards dated from the reorganization of the line in 1897 and was as strong in 1898 as in 1899.

395. The trend upwards may be seen from the following:

Oregon Short Line

	Predecessor road—1896	New road and predecessor road—1897	New road 107 days Mar. 16–June 30, 1897	Fiscal 1898	Fiscal 1899
Gross earnings	$5,632,726.20	$5,726,247.59	$1,720,797.25	$6,317,058.55	$7,577,108.38
Expenses and taxes	3,114,662.45	3,479,379.36	882,727.05	3,588,460.41	4,751,620.52
Net earnings	2,518,063.75	2,246,868.23	838,070.20	2,728,598.14	2,825,487.86
Income from other sources	Unavailable	Unavailable	2,073.55	198,984.85	437,649.02
Available for fixed charges	Unavailable	Unavailable	840,143.75	2,927,582.99	3,263,136.88
Surplus	Unavailable	Unavailable	Unavailable	158,994.66	346,363.55

396. (a) At the time of the exchange offer, the physical condition of the Oregon was improving.

(b) Defendant's expert testified that nevertheless the physical condition of the Oregon "still left a good deal to be desired."

(c) It is found that the testimony in the foregoing subparagraph (b) is rejected as vague and subjective, unsupported and unconvincing.

397. (a) The defendant's expert testified that

(1) For the 9-year period 1889–1898, adjusted earnings for the Oregon and its predecessor, exclusive of interest on Oregon bonds held by the reorganization committee and dividends received on Oregon Navigation preferred stock, averaged $2,379,076, while for the 5 year period 1893–1898, on a comparable basis, earnings averaged less, at $2,150,987. Neither of these averages was equal to the pro forma fixed and contingent charges of $2,804,710 for the fiscal year ending June 30, 1899. In the fiscal year ended June 30, 1898, operating earnings rose to $2,728,598, to which approximately $60,000 of other income may be added. In the fiscal year ended June 30, 1899—which covered a period ending beyond the acquisition of most of the Oregon stock by the U.P.—earnings amounted to $2,961,197 as adjusted.

(2) If the foregoing figures are capitalized at 5, 6 and 7 percent, the following earnings valuations result:

Oregon Short Line and Predecessor

Capitalization rate	Average annual earnings of $2,379,076 for 9 years 1889–98	Average annual earnings of $2,150,987 for 5 years 1893–98	Earnings of $2,788,598 in fiscal year ended June 30, 1898	Earnings of $2,961,197 in fiscal year ended June 30, 1899
5 percent	$47,581,520	$43,019,740	$55,771,960	$59,223,940
6 percent	39,651,267	35,849,783	46,476,633	49,353,283
7 percent	33,986,800	30,728,386	39,837,114	42,302,814

(3) Comparably to finding 366, regarding capitalization of U.P.'s earnings, a 5 percent rate also seems unwarranted for the Oregon on the basis of the road's financial difficulties, though recognition must be given to the fact that the Oregon Short Line and Utah Northern had very poor earnings only in 1894. Considering the not too unsatisfactory past record of earnings, a 7 percent rate of capitalization perhaps would

suggest too speculative an appraisal, an approach not warranted by the facts. Thus a 6 percent rate appears to be a reasonable rate of capitalization. This, according to the above table, produces a range of around $35.8 million to $49.3 million. Again, to give recognition to recency of earnings and admittedly an improving position for the reorganized Oregon, it is appropriate to average the four figures—which produces an earnings valuation of about $42.8 million. Similar treatment of the 5 percent capitalization rate would produce an earnings valuation of $51.4 million. The mean between these two foregoing figures, or $47.1 million—which would produce about a 5½ percent capitalization rate—is justified on the basis of the reasonably stable past record of earnings and the strong uptrend at the time of the Oregon acquisition by U.P. This earnings valuation figure of $47.1 million was the fair market value of the Oregon, exclusive of the value of the Oregon's stockholdings in Oregon Navigation Company.

(b) It is found that the foregoing testimony and conclusions are rejected as conclusions on fair market value, as overemphasizing past earnings and giving too little weight to current earnings, to the good prospects for future earnings, to the significance of the essential position of the Oregon Short Line and Oregon Railroad and Navigation in the reconstitution of the U.P. system and to the increasing national prosperity.

(ii) *Value of the Oregon's Holdings in Oregon Navigation*

398. The Oregon Short Line held $976,900 par value 4 percent participating preferred (of a total of $11 million) and 162,814 shares of common (of a total of $24 million) of Oregon Navigation Company. Oregon Navigation was the successor to the Oregon Railway and Navigation Company, which had been in receivership from 1893 to August 7, 1896. As noted above, the significance of Oregon Navigation was that it gave the Oregon Short Line an extension to the West Coast from the end of the Oregon Short Line at the Idaho-Oregon border. On the subject of Oregon Navigation and its place in the U.P.-Oregon system, see findings 326–331.

399. In the year ended June 30, 1898, the last fiscal year preceding the U.P.'s exchange offer for Oregon Short Line stock, Oregon Navigation enjoyed a sharp upsurge in earnings to $6.12 per share on the common.

400. Dividends were initiated on the new preferred stock in July 1897, in the first year after reorganization, with a payment of 1 percent, and were followed by similar payments in October 1897 and in January and April 1898, so that the full 4 percent was paid in the fiscal year ended June 30, 1898. The full 4 percent was also paid in the 1899 fiscal year, including 2 percent on July 2, 1898. On the latter date, a 1 percent dividend was paid on the common, the only dividend payment on the common up to the time of the exchange offer.

401. (a) Defendant's expert testified that

At the time of the exchange in the early months of 1899, Oregon Navigation had been operating free of the protection of the court for only about 2½ years and that the stocks of the reorganized company therefore were unseasoned and no dividend record of any significance existed.

(b) It is found that the foregoing testimony is rejected. The implication of fragility from the phrase "free of the protection of the court for only about two and one-half years" is misleading. The road was flourishing. Earnings were on the rise. Profit in fiscal 1898 was outstandingly good, jumping to an impressive $6.12 per share on the common stock; in the following year, in which the exchange took place, earnings declined slightly to $5.88 per share. Dividends had begun and prospects for earnings and continued rise in values were good. The reference to lack of "seasoning" and no "dividend record of any significance" is an unwarranted coloration of the underlying values. Many roads were reorganized following the Panic of 1893. A first dividend after reorganization, so soon after reorganization as in this case, is a good sign and not an occasion for pessimistic notes. Defendant's expert characterized Northern Pacific's dividend in 1897, after its reorganization in 1896, as one which the declaring road "lost no time" in declaring after it "benefited strongly from the excellent crop harvest in the fall of 1897." Oregon Navi-

gation doubtless benefited from the same harvest and defendant's expert could just as well have said that Oregon Navigation, too, "lost no time" in declaring its first dividends, in 1897.

402. (a) The defendant's expert testified that

(1) In the 9½ years, December 1889–June 1898, earnings of Oregon Navigation available for fixed charges had averaged $1,327,783 annually. On a pro forma basis for the 9½ years (after allowing for approximate depreciation on water equipment and fixed charges in the fiscal year ended June 30, 1898, the first full year of operation following emergence from receivership), net income averaged about $373,000, a sum which would be insufficient to cover the new post-reorganization preferred dividend requirements of $440,000 in full, let alone leave something for the new common stock. In fact, the amount by which net income fell short of what would be preferred dividend requirements ($67,000) was equal to 28 cents per share on the common stock.

(2) In the 5½ year period, January 1, 1893–June 30, 1898, average earnings were slightly poorer than in the aforementioned 9½ year record. As a result, net income in that period fell short of what would be the new preferred dividend requirements by an amount equal to 45 cents per share. Notwithstanding the mentioned inadequacy of earnings in the two periods mentioned, the profit in the last fiscal year in each of them was outstandingly good, jumping to an impressive $6.12 per share on the common stock in the fiscal year ended June 30, 1898. In the following fiscal year, during which the U.P. exchanged its stock for most of the Oregon Short Line stock outstanding, earnings on Oregon Navigation common stock declined slightly to $5.88 per share.

(3) On the basis of the average earnings over the periods of years, preferred and common stocks of the reorganized Oregon Navigation would appear to have had little intrinsic value.

(b) It is found that the foregoing testimony and conclusions are rejected for the same reasons as in the case of the Oregon Short Line, set out in finding 397(b).

403. Reflecting the rising fortunes of Oregon Navigation, the publicly held voting trust certificates (referred to here-

after as "vtc") for its preferred and common stocks experienced sharp advances in the year prior to acquisition of most of the Oregon Short Line stock by the Union Pacific. In 1898, the vtc's for the preferred stock rose from a low of 65½ on March 29 to a high of 78 on November 11. At the end of January, 1899, they sold at 76 and did not vary too much from this level during the rest of the first half of the year, prices generally having been around 72–73. Common stock vtc's rose sharply from a low of 35½ on January 7, 1898, to 61½ on August 22 of the same year. In January, 1899, they fluctuated between a high of 52 and a low of 48½, ending the month on a quotation of 49½–51.

404. The mean between the high and the low for the Oregon Navigation preferred stock vtc's in 1898 was 71¾, while that for the common stock vtc's was 48½. Neither of these differed too materially from the January 1899 month-end quotations of 76 for the preferred vtc's and 49½–51 for the common vtc's. During the rest of the first half of 1899—while most of the Short Line stock was being exchanged for the common stock of the Union Pacific—the vtc's for the preferred showed general firmness due to the payment of full dividends, while the vtc's for the common were in a generally declining trend.

405. Actual sale prices and quotations (the latter indicated by "*") for Oregon Navigation's preferred and common vtc's at or close to the end of each month in the first half of 1899 were as follows:

	January	February	March	April	May	June
Preferred	76	*70–72	72	69¾	*69–72	72–73¼
Common	*49½–51	*40–46	44	*40–45	34¾	37½–38½

406. (a) The defendant's expert testified that

In the light of the foregoing earnings figures—showing inadequate net income over 9½ year and 5½ year periods, but good profits in the 1898 and 1899 fiscal years—it appears that the fair valuations to use for the preferred and common vtc's as of January 1899 are the average market prices for 1898. On this basis, the 9,769 preferred stock vtc's of the Oregon Navigation Company held by the Oregon Short Line would have a value of $700,926 ($9,769×71¾), while the 162,814 com-

mon stock vtc's held would have a value of $7,896,479 ($162,814×48½), a combined total of $8,597,405. If prices for the common stock vtc's in the first half of 1899 were taken into consideration, the market valuation would be lower. However, inasmuch as earnings of the Oregon Navigation held up well in the 1899 fiscal year, there appears to have been no basic reason for the declining trend for the common stock vtc's. Accordingly, the aforementioned combined total of $8,597,405 is the fair market value adopted for the Oregon Short Line's holdings of Oregon Navigation during the Oregon Short Line-Union Pacific exchange. If this valuation is added to the previously adopted fair market value of $47.1 million for Oregon Short Line (exclusive of its holdings in Oregon Navigation), the total would be approximately $55.7 million.

(b) The foregoing testimony and conclusion are rejected for the reasons stated in finding 397(b), and as overly influenced by past earnings in depression and reorganization years; as an unwarranted adoption of stock market prices as the fair market value for large blocks of stock; and as giving too little weight to current and prospective earnings and values, to the significance of the essential position of the Oregon Short Line and Oregon Navigation in the reconstitution of the U.P. system and to increasing national prosperity.

(iii) *Defendant's Conclusion on the Value of the Oregon Short Line and Its Holdings*

407. (a) The defendant's expert testified that

Oregon Short Line stock at the time of the exchange offer from Union Pacific appears to have been overpriced if consideration is given to (1) the probable absence of asset value for Oregon Short Line common stock, (2) the fact that the improved earnings of the Oregon Short Line for the 1899 fiscal year (exclusive of dividends received from Oregon Navigation or equity in its earnings) still amounted to only 57 cents per share before sinking funds, and (3) the value of the Oregon Navigation preferred and common stocks owned by the Oregon Short Line, as calculated above. To

have justified a price of around 42 would have required a valuation of around $65.6 million for Oregon Short Line, a level apparently not warranted on the basis of either property or earnings, plus the value of Oregon Navigation stock held. The inference may be drawn that stockholders of the Oregon Short Line received more than adequate treatment.

(b) It is found that the foregoing testimony and conclusions—particularly the conclusion that at the market price of 42 the Oregon Short Line stock "appears to have been overpriced" and that the stockholders of the Oregon Short Line received "more than adequate treatment" in the exchange—are rejected for the reasons stated in findings 397(b) and 406(b) and as overly influenced by past earnings in depression and reorganization years and by asset values, as giving too little weight to current earnings, the prospects for increasing earnings and to the significance of the essential position of the Oregon Short Line and the Oregon Navigation in the reconstitution of the U.P. system and to increasing national prosperity.

(d) *Value of the U.P. at the Time of the Exchange*

408. The influences which were bringing about increases in the earnings of the Oregon lines, described above, were at work, too, on behalf of the U.P., so that at the time of acquisition of the Oregon Short Line, the U.P. in a brief time had become a considerably stronger road than it had been when it emerged from reorganization. Its earnings were in a strong upward trend, as its report for the fiscal year ended June 30, 1899, subsequently disclosed. Furthermore, considerable progress already had been made on the ambitious program of property and equipment improvement initiated under the leadership of Mr. Harriman. In addition, between November 1, 1898, and February 1, 1899, the U.P. reacquired 924.66 miles of its former branch lines free and clear of mortgages other than those acquired and held by the U.P. itself. These lines, along with another 88 miles bought in June 1899, were purchased for $5,518,248.23 in cash without the issuance of stocks or bonds to reimburse the road's treasury. Acquisition of control of the Oregon

Short Line then gave the U.P. possession of 2,543.59 additional miles of line, 1,480.78 operated by the Oregon Short Line and 1,062.81 miles by the Oregon Railroad and Navigation Company. In addition, people close to the U.P. undoubtedly were aware at least as early as 1899 that the road would be entitled to receive a substantial cash distribution at some not too distant date from the receivers of the old Union Pacific Railway Company upon claims against that company, the new company having purchased substantial unsecured claims at large discounts. The distribution was made in November, 1899, with $5,249,089.97 going to the Union Pacific Railroad Company. See finding 325(b)(3).

(e) *The Value of the Several Blocks of Shares Issued in the Exchange*

(i) *The Stock Issued in 1899*

409. Of the 273,493 shares issued in the exchange, 267,019 were issued in 1899, in the period from January 26 through December 2, 1899.

410. Union Pacific common stock itself had without doubt become worth substantially more at the time of the exchange offer than when it was issued in the reorganization of early 1898. Marketwise it was reflecting its improved status in a rising trend on the New York Stock Exchange.

411. The prices for 1898 were as follows:

Month	Prices of common stock		Number of shares traded
	High	Low	
January			
February	23	21	2,100
March	23	16	43,771
April	21	18	37,997
May	24	20	93,395
June	26	23	87,470
July	25	23	23,682
August	35	24	293,379
September	34	29	289,954
October	33	32	128,897
November	40	31	255,425
December	44	37	420,228

412. From a low of 16 in March, the stock advanced vigorously in increasingly heavy trading volume, to 44⅜ in December, and to a peak of 50⅜ in February 1899 before it began a downward drift that culminated in a low of

38⅛ in June before a recovery developed. In the early weeks of the offer to the Oregon Short Line, the range of Union Pacific common was 50⅜–43⅝—which corresponded roughly to the price of the Oregon Short Line, allowing for the $3 payment required for Oregon Short Line stockholders. See finding 342.

413. In its strong rise from March 1898 to February 1899, the U.P. common was reflecting its advancing earnings and basically improved position, as well as the prospective exchange offer for the Short Line and the good earnings uptrends of the Short Line and the Oregon Navigation. Recognition should (defendant's expert testified that "some recognition probably should") also be given to earnings for fiscal 1899. Although it was of course impossible to know in January and February of 1899 the exact amount of earnings for the fiscal year ended June 30, investors would have a pretty good idea of a substantial improvement in earnings.

414. In fiscal 1899 net income amounted to $5,788,209. After allowing for full dividends on the preferred stock (instead of the 3½ percent actually paid), the remaining balance would have been $2,788,209, equal to $3.19 per share on the outstanding common stock, amounting to 875,053 shares of $100 par value. Moreover, since the U.P. owned as of June 30, 1899 about 96½ percent of the Short Line's stock and the Short Line in turn owned a majority of the common stock of the Oregon Navigation, the U.P. had substantial equity earnings in these properties not included in the abovementioned earnings of $3.19 per share of plaintiff's common. The total of $6.38 of course would have some influence on investors, aside from U.P.'s power to dispose of its affiliates' earnings.

Not until a number of other financial transactions involving the Short Line and Oregon Navigation were completed late in 1899, however, was the Union Pacific actually in a position to determine the disposition of the earnings of these affiliates. Plaintiff issued additional preferred stock in exchange for Navigation preferred, and it issued additional common in exchange for Navigation Company common.

1

Findings of Fact

415. After allowing for the abovementioned transactions, consolidated earnings of the U.P., the Short Line, and Oregon Navigation available for plaintiff's common stock on a pro forma basis would have amounted to $5.12 per share in the fiscal year ended June 30, 1899, on the basis of U.P.'s books.

The sum of $1,926,357 for permanent improvements was charged to operating expenses, and to that extent earnings were understated, although generally to the extent no depreciation was charged, the earnings were overstated. This sum of $1,926,357, amounting to $2.20 per share of common stock, if added to the $5.12, would bring total earnings to $7.32.

416. Notwithstanding the acquisition of the Oregon Short Line and the Oregon Navigation in 1899 and the achievement of distinct improvement in earnings in fiscal 1899, the common stock of the U.P. dipped in the middle of 1899, and did not rise substantially throughout calendar 1899. After setting a high of 50⅜ in February, the stock trended downward and made its low for the year at 38⅛ in June, just about as the good fiscal year was drawing to a close. From then on it rose to establish a new high of 51¼ in November.

Monthly price fluctuations in calendar 1899 were as follows:

January	50 –41¾	July	45¾–42
February	50⅜–45½	August	48 –43¼
March	49½–43⅝	September	48¼–42½
April	49 –44½	October	48¼–41½
May	46⅞–40½	November	51¼–46⅛
June	43¾–38⅛	December	51½–39¾

417. (a) The defendant's expert testified that

(1) The basic value of Union Pacific common stock increased substantially between the consummation of the Union Pacific reorganization in early 1898 and the exchange of Oregon Short Line stock in late January and February 1899. The substitution of some solid investment value behind Union Pacific common served to displace some of the potential speculative value that existed at the inception of the new company. The net effect was to add around $10–$15 per share to the fair market value of $22.50 for the stock at the reorganization period. Therefore, at the time of the Oregon Short Line exchange in January and February 1899, Union Pacific common stock had a fair market value of $35 per share.

(2) As it became increasingly apparent that Union Pacific was enjoying significant improvement in its earnings as the close of its fiscal year was drawing near, the conclusion must be drawn that the road's common stock steadily was gaining in fundamental value. By the time all the facts as to Union Pacific's earning power for the fiscal year ended June 30, 1899, were known in mid-December, 1899, the stock had become worth $45–$50 per share. Therefore, over and above the valuation of $35 per share indicated for January–February, 1899, there was an increment in value of about $1.25 per share each month for the rest of the year 1899, resulting in the following values for the Union Pacific common issued in 1899:

Period in 1899	Number of shares	Fair market value per share	Total valuation
Jan. 26 to Feb. 25	137,301	$35	$4,805,535.00
Feb. 26 to Mar. 4	68,650	35¼	2,419,912.50
Mar. 5 to Mar. 11	27,460	35⅜	971,397.50
Mar. 12 to June 30	31,642	38	1,202,396.00
July 1 to Dec. 1	1,966	43¾	86,012.50
Totals	267,019		$9,485,253.50

(b) The foregoing testimony and conclusions are rejected (1) as vague and imprecise ("increased substantially," "some solid investment value," "some of the potential speculative value," "around"); (2) as based on a conclusion (that the value of the stock was $22.50 in January 1898) which has been rejected (finding 385(b)) and because of the reasons for that rejection; (3) as containing an unwarranted implication of "potential speculative" value at January 31, 1898 (findings 320 et seq.); (4) on the ground that the conclusion that the "net effect" was to add no more than $10–$15 to the fair market value at the earlier date is unreasoned and arbitrary; (5) as giving too little weight to current and prospective earnings and to the reflection of improving values and the value of the acquisition of the Short Line to the U.P. system in the rise in stock market prices from 25⅞ in January 1898 to 50 in January 1899, and (6) as another instance of the witness' reluctance to give sufficient weight to anticipation of formal reports of earnings by even a few months, and thus

by implication confirming his failure to give sufficient weight to prospective earnings.

The expert's conclusion that the stock was worth $35–$36 in January–March, 1899 (when most of the stock in question was issued) and $47.50 in December, 1899 (when a relatively minute number of shares were issued) is, therefore, an unreasonable postponement by at least a number of months of the increase in value of the 233,411 shares issued in January–March, 1899 warranted by the improving earnings capable of being appreciated by investors in the second half of the fiscal year 1899.

(ii) *The 3,688 Shares Issued December 2, 1899–June 30, 1900*

418. Between December 2, 1899 and June 30, 1900, the U.P. issued 3,688 additional shares of its common pursuant to the exchange.

419. (a) The defendant's expert testified that

On the basis of Union Pacific's consolidated earnings of $8.76 per share in fiscal 1900 (computed without deduction for the appropriations from income which are the subject of count 8) compared with $5.12 a year earlier, there can hardly be any question that the road's common stock had achieved an entirely new value. Furthermore, it was becoming more apparent that the property was in sound condition and that the earning power was resting on a solid basis. The low operating ratio (operating expenses divided by gross revenues) of 51.59 also attested to the soundness of the operation. The Union Pacific common stock was entitled to sell at about 10–12 times earnings by the time well-informed investors could have become aware of the fiscal 1900 earnings. This presumably would have been in about July or August 1900. A 10–12 times multiple would have indicated a price of around 88–105 or a mean of around 96½. While this would represent a phenomenal gain over the valuation of 47½ indicated for December 1899 (finding 417(a)(2)), the supporting evidence warrants this finding. The fair market value of the 3,688 shares of Union Pacific issued between December 2, 1899, and June 30, 1900, was $72 per share, the average be-

tween the 47½ value as of December 1899 and the 96½ value as of July–August 1900. For the 3,688 shares issued, this produces a value of $265,536.

(b) The foregoing testimony and conclusions are rejected as based on valuations as of earlier dates which have been rejected and for the reasons for such rejection; as vague and subjective, unreasoned and arbitrary; as giving too little weight to current and prospective earnings; and as expressions again of the witness' reluctance to anticipate formal reports of earnings by even a few months.

(iii) *The 2,636 Shares Issued July 1, 1900–June 30, 1901*

420. Between July 1, 1900 and June 30, 1901, that is in the fiscal year 1901, the U.P. issued, pursuant to the exchange, 2,636 additional shares of its common, the last of the shares whose valuation is in issue.

421. (a) The defendant's expert testified that

Determining the fair market value of the 2,636 Union Pacific shares issued in the 1901 fiscal year poses a more complex problem because of the road's speculative ventures at the time, described above in findings 305–325. Earnings of the Union Pacific from its own normal railroad operations continued to move ahead soundly. Reported earnings for fiscal 1901 amounted to $9.09 per share (computed without deduction for the appropriations from income which are the subject of count 8), but would have been higher, had it not been for increased interest charges and an increase in the number of shares of common stock outstanding. These latter two developments were mainly due to the issuance of $100 million first lien convertible 4s, some of which already had been converted by the end of the 1901 fiscal year. Had it not been for these events, earnings would have been $10.31 per share and probably a price-earnings multiple of 12 would have been justified, giving consideration to the quality of the earnings and their trend. This would have indicated a valuation of around 124 for the stock.

(b) It is found that (1) the first sentence of the foregoing subdivision (a) of this finding is rejected because of the

characterization as "speculative" of the ventures which are the subject of findings 305–325; the reasons for the rejection appear in the cited findings; (2) the fifth and sixth sentences, being the last two sentences of the foregoing subdivision (a) of this finding, are rejected for failure to give sufficient consideration to prospects for rising earnings from the U.P.'s investments in Southern Pacific and Northern Pacific; the witness would charge the interest cost of these profitable investments against earnings and thereby lower his valuation, but he does not increase his valuation by any or any sufficient factor taking into account the prospective profits to the U.P. by reason of these profitable investments; and (3) the remaining sentences (the second through fourth sentences) are accepted, and the facts therein are found.

422. Union Pacific's fiscal 1901 total earnings on its common stock, with the addition of equity earnings on its investments in Northern Pacific and Southern Pacific, amounted to $14.81 per share, an improvement of $5.72 over the $9.09 earned by U.P. alone, as follows:

Shares owned by U.P. system, June 30, 1901	Equity earnings per share	Total equity of U.P. in earnings
370,230 NP common stock	$7.77	$2,876,687.00
410,850 NP pfd. stock	4.00	1,643,400.00
750,000 SP common stock	5.93	4,447,500.00
Total		8,967,587.00
Additional fixed charges:		
$93,957,000×4 percent for 10 months		3,131,900.00
Net addition to earnings		5,835,687.00
Net addition to earnings per share of U.P. common stock (1,020,300 shares)		5.72
Actual U.P. earnings per share		9.09
Total earnings per share (consolidated)		14.81

At a multiple of 12 the earnings of $14.81 would give a value of $177.72 per share. At 11, the value would be $162.91.

423. (a) The defendant's expert testified that

It should be noted that dividends on the Northern Pacific preferred and common stocks held would have produced at $4 per share (the rates paid in fiscal 1901) a total of $3,124,320, or less than the interest requirements on the new first lien 4s. The equity earnings in Southern Pacific common stock amounted to $4,447,500 (750,000 shares times

$5.93), equal to $4.36 per share of Union Pacific common. Since Southern Pacific's earnings were not of as good quality as Union Pacific's or Northern Pacific's, this indicates that the net addition to Union Pacific's per share earnings warrants a lower price-earnings multiple.

(b) The foregoing testimony is rejected, not because of the arithmetical facts stated, but because of unwarranted implied depreciations of value, as follows: (1) the witness puts aside the equity earnings on Northern Pacific, $4,520,087 (see finding 322(a)) in favor of a lower figure, $3,124,320, the dividends paid; (2) the lower figure is then noted to be less than the interest requirements on the new bonds (if $3,131,900 for 10 months, then $3,758,280 for 12 months); (3) then the equity earnings of Southern Pacific are asserted to be not of as good quality as those of Northern Pacific, upon which it is concluded that as the "net addition" to U.P. earnings they "warrant(s) a lower price-earnings multiple" by which is presumably meant a value-earnings multiple. The net addition to earnings was in fact $5,835,687 or $5.72 per share for the 1,020,300 shares outstanding (see finding 418(a)). Even if a lower multiple than that impliedly admitted by the witness to be warranted for the U.P. were utilized, the valuation would be:

U.P.'s own earnings per share $9.09, at a multiple of 12	$109.08
The net addition of $5.72 per share at a multiple of 10	57.20
Total	166.28

424. (a) The defendant's expert testified that

In order to determine the true earning power of Union Pacific common stock in fiscal 1901, the pro forma earnings (including equity earnings in Northern Pacific and Southern Pacific) should be calculated on the assumption of full conversion of the new first lien 4s. This would eliminate the interest requirements on these bonds but increase substantially the number of Union Pacific common shares outstanding from 1,020,300 to 1,959,870. On this basis, earnings

on the common (including equity earnings in Northern Pacific and Southern Pacific) would have been equal to $9.63 per share, including $2.27 per share in Southern Pacific's profits. Thus, on a fully converted basis, earnings on Union Pacific common would have improved only slightly over the actual $9.09 per share and would have deteriorated quality-wise. However, because of the potentially strategic value of the Northern Pacific and Southern Pacific acquisitions, a genuine improvement occurred in the value of Union Pacific common. Therefore, by the end of the 1901 fiscal year, the fair market value of Union Pacific common was around 120–125, or a mean of 122½ (or about 12.7 times the earnings figure of $9.63). Giving double weight to the significant events of the second half of the fiscal year, the fair market value for the 2,636 shares of U.P. common issued during the fiscal year was $112 per share, resulting in an aggregate valuation of $295,232.

(b) The foregoing testimony and conclusion are rejected because

(1) They are based on earlier valuations which have been rejected and contain the same faults as those valuations, and they are unwarrantedly depreciative of current earnings and fail to recognize the current and prospective additions to value of the U.P.'s investments in Northern Pacific and Southern Pacific.

(2) To assume full conversion of the new bonds is unrealistic and serves only to depress earnings per share in the current year. The convertibility feature of the bonds was so designed as to bring about conversion only when profits rose (as in fact occurred, see finding 309). Full conversion came when U.P. was at a high point of profits and had just declared a 10 percent dividend. If full conversion were to be assumed, in fairness it would be appropriate also to assume the profits which would bring about full conversion and be available as per share earnings for an estimate of value.

It would be realistic and fair to reason that the interest cost of the bonds, just issued, is a deduction from the profits realized, and then consider the enduring and increasing profits realized, for purposes of valuation. This the witness does

not do. Rather, first he converts these bonanza investments of the U.P. into a slight improvement, with a decline in quality, in U.P.'s earnings and then, grudgingly recognizing a "potentially" strategic value for U.P. in Northern Pacific and Southern Pacific, he finds a "genuine improvement" over his valuation of $72 for the next earlier period (finding 419 (a)). This improvement he assesses, as a matter of his unexplained judgment, at $40.

(f) *Price-Earnings Ratios and Other Comparisons for 1899–1901*

425. (a) The defendant's expert testified that

(1) The fair market values determined above for Union Pacific common for January 26, 1899, through June 30, 1901, are also warranted by reference to the price-earnings ratios for Union Pacific common and the ten other railroad stocks listed in finding 379. Consideration was given first to the price-earnings ratios as of January 26, 1899, based on earnings for fiscal or calendar 1898 and fiscal or calendar 1899. These were as follows:

	Mean price, Jan. 26, 1899	Earnings per share on common; fiscal years ended		P/E ratio based on earnings for—	
		une 30, 1898	June 30, 1899	1898	1899
UP	$48.3125	[f] $2.95	[i] $3.44	16.4	[j] 14.0
AT & SF	23.5625	[c] 3.80	1.49	----------	----------
CBQ	138.75	8.37	7.74	16.6	17.9
CMSTP	129.1875	[h] 9.06	[h] 11.51	14.3	11.2
CNW[a]	151.375	[h] 9.51	[h] 11.97	15.9	12.6
GN[b]	167.125	23.29	8.34	7.2	20.0
IL	120.625	8.60	8.49	14.0	14.2
NYC & HR	138.5625	4.95	5.91	28.0	23.4
NP vtc[c]	50.625	4.64	6.01	10.9	8.4
PRR[d]	[e] 68.625	3.96	4.06	17.3	16.9
SP	38.5	4.88	4.55	7.9	8.5

[a] Fiscal years ended May 31.
[b] All figures relate to preferred stock, the only class outstanding.
[c] vtc means voting trust certificates.
[d] Calendar year.
[e] Price equals one-half of mean on New York Stock Exchange, where quotations were in percentage of par value; the par value of Pennsylvania was $50.
[f] Estimated on pro forma basis.
[c] Deficit.
[h] Participating basis.
[i] Pro forma, assuming all properties owned June 30, 1899, had been owned throughout the fiscal year. Actual earnings were $3.19 per share. Following certain financial transactions in the second half of 1899, it was reported in mid-December 1899 that combined earnings of U.P., OSL and ORR & N would have been equal to $5.12 per share on the common stock.
[j] On basis of $5.12 earnings mentioned in note (i) above, the P/E ratio would have been 9.4.

Due to the fact that the prices of the stock uniformly were higher on January 26, 1899, than on January 31, 1898, the price-earnings ratios based on fiscal or calendar 1898 earnings were higher too. Except for New York Central's very high 28.0 (attributable in part to the fact that reported earnings of that System were understated because they were not reported on a consolidated basis), the price-earnings ratios of the dividend-paying railroads—whose ranks were joined by Northern Pacific—ranged from 17.3 to 7.2. The multiple for Southern Pacific was 7.9, while that of Union Pacific (based on a market price of 48.3125 and earnings of $2.95) was 16.4, a figure not much below the Pennsylvania's 17.3 and Chicago, Burlington and Quincy's 16.6, and above the ratios of all the other dividend-paying railroads, save for the New York Central. Utilization of fiscal 1898 earnings and the above-determined fair market value of $35 for Union Pacific common as of January 26, 1899, results in a multiple of 11.9, which is still in excess of the multiples for Great Northern, Northern Pacific, and Southern Pacific.

(2) On the fiscal or calendar year 1899 earnings, the ratios of the dividend-paying rails on January 26, 1899, ranged from 23.4 to 8.4, while the nondividend-paying Southern Pacific had a multiple of 8.5. Union Pacific's ratios of 14.0 based on the market price of $48 and 10.2 based on the fair market value of $35 exceeded the multiples of 8.5 for Southern Pacific and 8.4 for Northern Pacific, and the former but not the latter also exceeded the multiples of 11.2 for the St. Paul and 12.6 for the North Western.

(b) The foregoing testimony and conclusion—that the price-earnings ratios cited "warrant" or support the conclusions of the witness on the fair market value of U.P. common issued from January 26, 1899 through June 20, 1901—are rejected for the following reasons:

(1) The testimony has no relation to and gives no support to the witness' conclusion—basic to his valuations for January 26, 1899–June 30, 1901—that U.P. common issued in January 1899 was worth $35 per share.

(2) For, also, the reasons stated in finding 382.

(3) The U.P. earnings used to compute the witness' ratios are $3.19 or $3.44 per share, not $5.12 as would be more correct, or $7.32, also tenably correct (see finding 415).

(4) The witness at some points compares a ratio which is the product of a ratio of (his) *value* of U.P. share to earnings with a ratio which is the *price* of other railroads to earnings, a comparison which conveys nothing.

426. For the two periods during which relatively small amounts of Union Pacific common stock were issued in exchange for Oregon Short Line stock—namely, December 2, 1899–June 30, 1900, and July 1, 1900–June 30, 1901—the fair market values testified to by defendant's expert herein, $72 and $112, respectively, are considerably above market price at the time. See finding 342. The period was one of undervaluation for railroad stocks generally. For the most part, earnings were strong in fiscal and calendar 1900. In the following year, results were even more spotty, with some roads showing moderate declines while others realized further gains. In the two-year period the common stocks of many roads sold at relatively low price-earnings ratios, several in fact at less than ten times earnings.

427. (a) The defendant's expert testified that

The average monthly price of Union Pacific common (51.34) in the seven-month period December 1899–June 1900 was only 5.9 times the earnings of $8.76 realized in fiscal 1900. This ratio was no better than that for Atchison, Topeka and Santa Fe common, which was just emerging from a string of deficits. Average monthly prices of the common stocks of the Milwaukee, the North Western, the Northern Pacific, and the Southern Pacific were about ten (or less) times the earnings for fiscal 1900. Thus, of the eleven roads considered, six were in this classification. Even Pennsylvania (on a calendar year basis) and Illinois Central, two of the strongest roads of the era, sold at less than 12 times earnings. It is concluded that rail stocks at the time were unreasonably low and the value of $72 determined for Union

Pacific common for the period covered represents fair market value more accurately than did the actual market price. The value of $72 is 8.2 times the earnings of $8.76 for fiscal 1900, a multiple in excess of the 6.8 for Northern Pacific and 5.9 for Santa Fe and not much below the multiples of 9.4 for Southern Pacific and 9.7 for the North Western.

(b) The foregoing testimony and conclusion are rejected

(1) as vague and inconclusive.

(2) because the testimony that $72 represents fair market value "more accurately" than the market price of $51.34, in view of the Government's position and the witness' testimony, is no support for a valuation of $72. Such testimony is consistent with the proposition that $100 or $200 may represent market value still "more accurately."

(3) because the testimony concerning price-earnings ratios, presumably factual enough, has no relation to and offers no support for the witness' conclusion of a $72 fair market value for the stock issued between December 1899 and June 1900; see the reasons for the rejection of comparative price-earnings data stated in finding 382.

(4) finally, the witness in the last sentence of subdivision (a) of this finding again compares (his) *value* (of U.P.)-earnings ratios with (other railroads') *price*-earnings ratios.

428. For the last period, fiscal 1901, the price-earnings ratios for the eleven roads considered show that, although average monthly prices in fiscal 1901 were a good deal higher than in the preceding seven months, general undervaluation still persisted. In terms of earnings for fiscal or calendar 1900, price-earnings ratios had improved, but, for many roads, they were still low with respect to profits for fiscal or calendar 1901, particularly in the light of the general prosperity of the period. In fact, four of the six roads with price-earnings ratios of about ten or under, based on fiscal or calendar 1900 earnings, fell in the same category on 1901 earnings. Similarly, Pennsylvania and Illinois Central continued to sell at modest ratios, considering their stature. U.P.'s average monthly price of 79.83 for the 12 months ended

June 30, 1901, was a conservative 8.8 times earnings of $9.09 per share for the same period. Moreover, it was only 5.4 times earnings of $14.81, including equity in the earnings of Northern Pacific and Southern Pacific. The price-earnings ratio would have been 8.3 if allowance is made for conversion into common stock of the outstanding first lien convertible 4s, resulting in earnings of $9.63.

Regardless of the approach taken, the average monthly price of U.P. common in the 12 months ended June 30, 1901, was low at 79.83. Recognition of this did occur as the fiscal year progressed, for the average price in June 1901 was 110.38, compared with 54.19 in July 1900, and the trend was almost continuously upward. In May 1901, just before the brief "Panic of 1901" broke loose, the stock attained a peak of 133. It had crossed 100 for the first time in April 1901, reaching a high of 120 that month.

429. (a) The defendant's expert testified that

The correctness of the fair market value of $112 determined for U.P. common for fiscal 1901 is also confirmed by the fact that, based on the earnings figure of $9.63, it reflects a multiple of 11.6 which was significantly exceeded by the multiples for only three of the ten other roads studied: the Burlington, Great Northern, and the New York Central. The multiple of 12 was about the same as the multiples of 13.3 for the St. Paul, 12.1 for the Illinois Central, and 12.9 for the Pennsylvania.

(b) The foregoing testimony and conclusion are rejected for the reasons stated for the rejection of the testimony and conclusion recounted in findings 370–382, 382(b).

13. *Court's Conclusions on Value*

430. The court finds the New York stock exchange prices for the U.P. stock provide the best evidence of value in this case.

431. The average between high and low for the U.P. preferred on February 2, 1898 (*see* finding 236, the valuation date adopted by the court) was $62.50 (*see* finding 344).

Findings of Fact

432. The value of the U.P. preferred issued in the reorganization was, therefore, $62.50 x 750,000 shares or $46,875,000.

433. The derived price for the U.P. reorganization common on February 2, 1898 is $26.625. This is derived from the average price of trust receipts on February 2, 1898 (*see* finding 338) of $36. Since one trust receipt was exchangeable for one new share of U.P. common and $^{15}/_{100}$ of a share of new preferred ($^{15}/_{100}$ of $62.50 is $9.375), by subtracting the value of the preferred increment ($9.375) from the trust receipt value ($36.), we derive the price for U.P. reorganization common on February 2, 1898 of $26.625.

434. The value of the 610,000 shares of U.P. common issued in the reorganization was, therefore, 610,000 x 26.625 or $16,241,250.

435. We find that the following time periods, and average market prices for such time periods represent the most accurate values for the U.P. acquisition common. (*See* finding 347.)

From	*To*	*Number of shares*	*Average*	*Total Value*
1-26-99	2-25-99	137, 301	$46. 00	$6, 315, 846
2-26-99	3- 4-99	68, 650	47. 00	3, 226, 660
3- 5-99	3-11-99	27, 460	47. 00	1, 290, 620
3-12-99	6-30-99	31, 642	44. 00	1, 392, 248
7-11-99	12- 1-99	1, 966	46. 00	90, 436
12- 2-99	6-30-00	3, 688	50. 50	186, 244
7- 1-00	6-30-01	2, 636	91. 50	241, 194
7- 1-01	6-30-02	50	175. 00	8, 750
7- 1-07	6-30-08	100	175. 00	17, 500
		273, 493	----------	$12, 769, 188

436. We, therefore, find a value for the acquisition common of $12,769,188.

437. The total value for the U.P. stock issued in the reorganization ($16,241,250 for the common; $46,875,000 for the preferred) and the acquisition ($12,769,188 for the common) of $75,885,438.

CONCLUSION OF LAW

Upon the foregoing findings of fact and opinion, which are adopted by the court and made a part of the judgment herein, the court concludes as a matter of law that plaintiff is entitled to recover on its claims in Parts I, V and some sections of Part X; that plaintiff may not recover on its claims in Parts II, IV, VI and VII; and that defendant has the right to recover on its additional defenses in Parts VIII, IX and XI. The amount of the recoveries will be determined pursuant to Rule 131(c). Further, the court hereby remands Part III to the trial division for further proceedings consistent with this opinion.

APPENDIX

Schedule 1

Year	Column (1)	1942	1943	1944	1945	1946	1947	1948	1949	1950	1951	1952	1953	1954	Year
1942	$113,718	$3,972	$7,581	$7,581	$7,581	$7,581	$7,581	$7,581	$7,581	$7,581	$7,581	$7,581	$7,581	$7,581	1942
1943	159,929		5,331	10,662	10,662	10,662	10,662	10,662	10,662	10,662	10,662	10,662	10,662	10,662	1943
1944	200,615			6,690	13,374	13,374	13,374	13,374	13,374	13,374	13,374	13,374	13,374	13,374	1944
1945	210,487				7,020	14,032	14,032	14,032	14,032	14,032	14,032	14,032	14,032	14,032	1945
1946	166,762					5,562	11,117	11,117	11,117	11,117	11,117	11,117	11,117	11,117	1946
1947	133,747						4,462	8,916	8,916	8,916	8,916	8,916	8,916	8,916	1947
1948	128,013							4,269	8,534	8,534	8,534	8,534	8,534	8,534	1948
1949	137,939								4,598	9,196	9,196	9,196	9,196	9,196	1949
1950	119,626									3,988	7,975	7,975	7,975	7,975	1950
1951	164,820										5,494	10,988	10,988	10,988	1951
1952	182,448											6,083	12,163	12,163	1952
1953	191,703												6,392	12,780	1953
1954	154,031													5,133	1954
1955	154,635														1955
1956	159,909														1956
1957	162,560														1957
1958	141,894														1958
1959	128,507														1959
1960	104,810														1960
1961	107,449														1961
1962	122,995														1962
1963	134,578														1963
1964	133,249														1964
1965	146,247														1965
1966	157,501														1966
1967	152,472														1967
Totals		$3,792	$12,912	$24,933	$38,637	$51,211	$61,228	$69,951	$78,814	$87,400	$96,881	$108,458	$120,930	$132,451	

Schedule 1—Continued

Year	Column (1)	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	Year
1942	$113,718	$7,581	$7,581	$3,792											1942
1943	159,929	10,662	10,662	10,662	$5,330										1943
1944	200,615	13,374	13,374	13,374	13,374	$6,689									1944
1945	210,487	14,032	14,032	14,032	14,032	14,032	$7,019								1945
1946	166,762	11,117	11,117	11,117	11,117	11,117	11,117	$5,562							1946
1947	133,747	8,916	8,916	8,916	8,916	8,916	8,916	8,916	$4,461						1947
1948	128,013	8,534	8,534	8,534	8,534	8,534	8,534	8,534	8,534	$4,268					1948
1949	137,939	9,196	9,196	9,196	9,196	9,196	9,196	9,196	9,196	9,196	$4,597				1949
1950	119,626	7,975	7,975	7,975	7,975	7,975	7,975	7,975	7,975	7,975	7,975	$3,988			1950
1951	164,820	10,988	10,988	10,988	10,988	10,988	10,988	10,988	10,988	10,988	10,988	10,988	$5,494		1951
1952	182,448	12,163	12,163	12,163	12,163	12,163	12,163	12,163	12,163	12,163	12,163	12,163	12,163	$6,083	1952
1953	191,703	12,780	12,780	12,780	12,780	12,780	12,780	12,780	12,780	12,780	12,780	12,780	12,780	12,780	1953
1954	154,031	10,269	10,269	10,269	10,269	10,269	10,269	10,269	10,269	10,269	10,269	10,269	10,269	10,269	1954
1955	154,635	5,155	10,309	10,309	10,309	10,309	10,309	10,309	10,309	10,309	10,309	10,309	10,309	10,309	1955
1956	159,909		5,328	10,661	10,661	10,661	10,661	10,661	10,661	10,661	10,661	10,661	10,661	10,661	1956
1957	162,560			5,421	10,837	10,837	10,837	10,837	10,837	10,837	10,837	10,837	10,837	10,837	1957
1958	141,894				4,727	9,460	9,460	9,460	9,460	9,460	9,460	9,460	9,460	9,460	1958
1959	128,507					4,285	8,567	8,567	8,567	8,567	8,567	8,567	8,567	8,567	1959
1960	104,810						3,496	6,987	6,987	6,987	6,987	6,987	6,987	6,987	1960
1961	107,449							3,584	7,163	7,163	7,163	7,163	7,163	7,163	1961
1962	122,995								4,098	8,200	8,200	8,200	8,200	8,200	1962
1963	134,578									4,485	8,972	8,972	8,972	8,972	1963
1964	133,249										4,444	8,883	8,883	8,883	1964
1965	146,247											4,874	9,750	9,750	1965
1966	157,501												5,251	10,500	1966
1967	152,472													5,081	1967
Totals		$142,742	$153,224	$160,189	$161,208	$158,211	$152,287	$146,788	$144,448	$144,308	$144,372	$145,101	$145,746	$144,502	

Schedule 2

Year	Amount	1927	1928	1929	1930	1931	1932	1933	1934	1935	1936	1937	1938	1939	1940	1941	Year
1927	$15,459	$513	$1,031	$1,031	$1,031	$1,031	$1,031	$1,031	$1,031	$1,031	$1,031	$1,031	$1,031	$1,031	$1,031	$1,031	1927
1928	16,846		562	1,123	1,123	1,123	1,123	1,123	1,123	1,123	1,123	1,123	1,123	1,123	1,123	1,123	1928
1929	18,319			613	1,221	1,221	1,221	1,221	1,221	1,221	1,221	1,221	1,221	1,221	1,221	1,221	1929
1930	14,625				488	975	975	975	975	975	975	975	975	975	975	975	1930
1931	10,700					359	713	713	713	713	713	713	713	713	713	713	1931
1932	5,782						196	385	385	385	385	385	385	385	385	385	1932
1933	6,082							206	405	405	405	405	405	405	405	405	1933
1934	7,322								245	488	488	488	488	488	488	488	1934
1935	8,899									299	593	593	593	593	593	593	1935
1936	9,602										321	640	640	640	640	640	1936
1937	10,127											339	675	675	675	675	1937
1938	8,311												278	554	554	554	1938
1939	9,732													323	649	649	1939
1940	50,343														1,680	3,356	1940
1941	77,485															2,581	1941
Totals....	$269,634	$513	$1,593	$2,767	$3,863	$4,709	$5,259	$654	$6,098	$6,640	$7,255	$7,913	$8,527	$9,126	$11,132	$15,389	

Year	Amount	1942	1943	1944	1945	1946	1947	1948	1949	1950	1951	1952	1953	1954	1955	1956	Year
1927	$15,459	$512															1927
1928	16,846	1,123	$562														1928
1929	18,319	1,221	1,221	$612													1929
1930	14,625	975	975	975	$487												1930
1931	10,700	713	713	713	713	$359											1931
1932	5,782	385	385	385	385	385	$196										1932
1933	6,082	405	405	405	405	405	405	$206									1933
1934	7,322	488	488	488	488	488	488	488	$245								1934
1935	8,899	593	593	593	593	593	593	593	593	$298							1935
1936	9,602	640	640	640	640	640	640	640	640	640	$321						1936
1937	10,127	675	675	675	675	675	675	675	675	675	675	$338					1937
1938	8,311	554	554	554	554	554	554	554	554	554	554	554	$277				1938
1939	9,732	649	649	649	649	649	649	649	649	649	649	649	649	$323			1939
1940	50,343	3,356	3,356	3,356	3,356	3,356	3,356	3,356	3,356	3,356	3,356	3,356	3,356	3,356	$1,679		1940
1941	77,485	5,166	5,166	5,166	5,166	5,166	5,166	5,166	5,166	5,166	5,166	5,166	5,166	5,166	5,166	$2,580	1941
Totals....	$269,634	$17,455	$16,382	$15,211	$14,111	$13,270	$12,722	$12,327	$11,878	$11,338	$10,721	$10,063	$9,448	$8,845	$6,845	$2,580	

Schedule 3

Donor	Class of Facility	Union Pacific Railroad	Oregon Short Line	Oregon-Washington Railroad & Navigation	Los Angeles Salt Lake	St. Joseph & Grand Island	Des Chutes	Yakima Valley Transportation	Saratoga & Encampment	Laramie & North Park Western	Total
As of December 31, 1939											
Governmental.	Relocation line account dams.	$2,560,019.91	$109,388.71	$3,322,701.60							$5,992,110.22
	Relocation line account highways.			11,669.22							11,669.22
	Relocation line account waterways.				$240,000.00						240,000.00
	Underpasses account highways.	425,981.23	497,437.08	139,999.63	492,019.25						1,555,437.19
	Highway crossings	53,623.71	36,760.58	7,591.28	19,962.98						117,938.55
	Spur or other tracks	22,397.25	236,233.48	9,340.39	3,978.55	$1,881.33					273,831.00
	Miscellaneous	114,620.69	78,375.09	55,252.62	72,342.96	9.95					320,601.31
Private	Industry spurs and other tracks.	317,536.31	144,948.95	158,167.41	159,873.96	1,397.42	$1,493.41	$5,082.39	$98,553.79	$4,300.87	891,354.51
	Miscellaneous	79,638.97	62,845.48	66,658.27	179,616.63	5,720.02	55.65	837.00		50.00	395,422.02
	Total for 12/31/39	$3,573,818.07	$1,165,989.37	$3,771,380.42	$1,167,794.33	$9,008.72	$1,549.06	$5,919.39	$98,553.79	$4,350.87	$9,798,364.02
During the Year 1940											
Governmental.	Relocation line account dams.	($32,396.21)		$163,296.26							$130,900.05
	Relocation line account highways.			(259.67)							(259.67)
	Relocation line account waterways.										
	Underpasses account highways.			5,153.36	$4,783.75						9,937.11
	Highway crossings	94.02									94.02
	Spur or other tracks			909.69							909.69
	Miscellaneous		$6,038.59	1,377.73	982.69						8,399.01
Private	Industry spurs and other tracks.	(11,491.40)	4,151.57	1,889.32	(11,715.55)		($256.88)		($57.19)		(17,480.13)
	Miscellaneous	(42,181.24)	3,009.61	217.00	(11.972)	(88.52)					(39,162.87)
	Total for Year 1940	($85,974.83)	$13,199.77	$172,583.69	($6,068.83)	($88.52)	($256.88)		($57.19)		$93,337.21

During the Year 1941

Governmental.	Relocation line account dams.			$763.33			$763.33
	Relocation line account highways.						
	Relocation line account waterways.						
	Underpasses account highways.	$197,699.67	$46,696.82	30,041.50	$238,589.62		513,027.61
	Highway crossings	(184.36)	(344.00)				(528.36)
	Spur or other tracks		6.00		1,267.76		1,273.76
	Miscellaneous	248.74	520.68				769.42
Private.	Industry spurs and other tracks.	11,085.57	4,768.14	(384.75)	1,071.89	($1,457.89)	(7,088.18)
	Miscellaneous	1,041.00	1,077.38	(184.70)	(260.17)		1,673.51
	Total for Year 1941	$187,719.48	$52,725.02	$30,235.38	$240,669.10	($1,457.89)	$509,891.09

During the Year 1942

Governmental.	Underpasses account highways.	($23,239.79)
	Spur or other tracks	(358.53)
	Miscellaneous	(93.52)
Private.	Industry spurs and other tracks.	2,161.24
	Miscellaneous	2,996.47
	Total for Year 1942	($18,534.13)

Schedule 4

Type of transferor and category	Name of project	Transferor	Transferee	Amount claimed by plaintiff	Year recorded	Page in Ex. 332	Pertinent exhibits—Pl. Ex. No.
Governmental:							
Relocation of line on account of dams.	Echo Dam	United States	Plaintiff	$402,641	1927–1930	UP 58 of 74	336–337
	Keystone Dam	Central Nebraska Public Power and Irrigation District and the United States.	Plaintiff	2,110,666	1939	UP 72 of 74	338–342
	Bonneville Dam (MP 37.58—41.84).	United States	Oregon-Washington Railroad & N. Co.	2,359,747	1935–1943	OW 67 of 72	343–344
	Bonneville Dam (MP 42.96—80.79).	United States	Oregon-Washington Railroad & N. Co.	1,200,729	1939–1941	OW 69 of 72	345–346
Embankments on account of dams.		United States	Oregon Short Line	23,800	1924	OSL 66 of 83	347
Relocation of line on account of highway construction.	Long Beach cutoff	City of Long Beach	Los Angeles & Salt L. Railroad Co.	240,000	1933–1935	LASL 41 of 45	348–350
Underpasses on account of highway construction.	Lawrence, Kansas, subway.	Kansas	Plaintiff	147,962	1938	UP 71 of 74	351–352
	Denver subway	Colorado and Denver	Plaintiff	120,088	1941	UP 73 of 74	353–354
	Pocatello subway	Idaho and Pocatello	Oregon Short Line R.R. Co.	152,316	1934–1938	OSL 75 of 83	355–356
	McCammon subway.	Bannock City	Oregon Short Line	5,049	1923	OSL 64 of 83	357
		California and Los Angeles.	LASL	81,985	1936	LASL 42 of 45	358
Bridges		Big Lost River Irrigation District.	Oregon Short Line	864	1935	OSL 77 of 83	359
		Shoshone City	OW	6,985	1929	OW 62 of 72	360–361
		California and Los Angeles.	LASL	131,149	1941		

Spur tracks	Denver subway	Colorado and Denver	UP	9,564	1939	UP 25 of 74
Viaducts and highway crossings		Oregon	OW	9,880	1923	OW 58 of 72
		Jefferson City	UP	400	1921	UP 47 of 74
		Nebraska	UP	15,515	1932	UP 66 of 74
		City of Ogallala	UP	43	1927	UP 56 of 74
Fences		Kansas	UP	145	1938	UP 70 of 74
Highway stop signs		Colorado	UP	5	1928	UP 60 of 74
Street lighting		Washington	OW	62	1929	OW 62 of 72
Crossing signals		California	LASL	1,443	1940	LASL 44 of 45
Siphons		United States	OSL	3,080	1924	OSL 65 of 83
Culverts		United States	OSL	2,937	1938	OSL 79 of 83
Telegraph lines		Colorado	UP	437	1934	UP 69 of 74
Outbuildings		United States	UP	129	1938	UP 71 of 74
Pipelines		Town of Cornish	OSL	456	1939	OSL 80 of 83
Cable		LA	LASL	6,999	1938	LASL 44 of 45
Private:						
Industry spurs and other tracks		Republic Chem. Works	Plaintiff	1,154	1919	UP 2 of 74
		Utah Idaho S. Co	OSL	6,976	1919	OSL 10 of 83
		Abilene Flour M	Plaintiff	729	1926	UP 13 of 74
		Superior Rock Springs Coal Co.	Plaintiff	278	1919	UP 2 of 74
		Rocky Mountain Fuel Co.	Plaintiff	1,221	1928	UP 16 of 74
		Amalgamated S.C	OSL	577	1936	OSL 34 of 83
		Utah P & L	OSL	7,770	1927	OSL 68 of 83
		So. Pac. Rr	LA & SL	1,997	1933	LASL 41 of 45
						LASL 41 of 45
Street lights and sewers		Holtzinger	OW	536	1924	OW 58 of 72
		Holtzinger	OW	665	1923	OW 57 of 72
Road crossings and fences		Meyer	UP	92	1919	UP 44 of 74
		Franklin County Sugar Co.	OSL	131	1929	OSL 71 of 83

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Schedule 4—Continued

Type of transferor and category	Name of project	Transferor	Transferee	Amount claimed by plaintiff	Year recorded	Page in Ex. 332	Pertinent exhibits—Pl. Ex. No.
Paving streets		Portland Flooring Mills Co. et al.	OW	9,169	1927	OW 59-60 of 72	392
Pipelines		Utah-Idaho Sugar Co.	OSL	129	1930	OSL 72 of 83	393
Stockyards and other facilities		Laramie Stockyards	UP	2,100	1921	UP 48 of 74	394
		Oxwald Corp.	UP	4,056	1942	UP 73 of 74	395
Culverts and siphons		Beaverhead Water Co.	OSL	631	1921	OSL 61 of 83	396
Telegraph line		NW Bell Telephone Co.	UP	197	1930	UP 63 of 74	397
Carbodies		Pac. Fruit Exp. Co.	UP	127	1922	UP 49 of 74	398
Track scales		Big Hole Stockman's Association.	OSL	354	1929	OSL 70 of 83	399
Platforms		Rocky Mountain Produce Co.	UP	415	1931	UP 65 of 74	400
Buses		UP Stages	UP	900	1939	UP 72 of 74	401
Railroad equipment		Timker Roller Bearing Co.	UP	9,942	1940	UP 73 of 74	402
Electric power and signal lines		Pac Fruit Exp. Co.	OW	444	1938	OW 68 of 72	403
Retaining walls		Magness Metal Co.	UP	1,364	1938	UP 71 of 74	404
Signals		Spokane, Couer d'Alene Palouse Railway Co.	OW	242	1929	OW 62 of 72	405
Line relocation		Utah Copper	LASL	127,317	1920	LASL 35 of 45	406-40

Syllabus

525 F. 2d 1028

ISMAIL ABDEL RAZIK v. THE UNITED STATES

[No. 340–74. Decided November 19, 1975]

ON PLAINTIFF'S AND DEFENDANT'S MOTIONS FOR SUMMARY JUDGMENT

Civilian pay; dismissal; charges and reasons for dismissal.—Plaintiff received notice of proposed removal for "repeated uncooperative, obstructive, insubordinate behavior and intemperate language," the the notice detailing specific incidents supporting the charges and advising plaintiff of his appeal rights. Plaintiff replied, largely admitting the specified events but offering mitigating circumstances. The agency determined that the charges were supported by the evidence and warranted removal. Plaintiff filed an intra-agency appeal and was accorded an evidentiary-type hearing before a hearing examiner who subsequently recommended removal. In assessing the agency's action, the hearing examiner broke down the above-quoted charge into three charges under which he cited evidence from the record appropriate to the charges. He also recommended that the agency retroactively grant plaintiff a within-grade increase previously withheld and pay plaintiff for a previous 3-day suspension. The Deputy Director accepted the examiner's removal recommendation, but disregarded the subsidiary recommendations. Thereafter the agency notified plaintiff that he was to be removed to promote the efficiency of the service. Plaintiff appealed to the Civil Service Commission Appeals Examining Office which found that procedural requirements and regulations had been observed, that the removal action was based on sustained charges and was not arbitrary, unreasonable or capricious. The action was concurred in on further appeal to the Civil Service Commission Appeals Review Board. In his suit here plaintiff contends that his removal is invalid by reason of specified alleged procedural errors. It is held (1) that the Deputy Director did not commit procedural error in excluding the hearing examiner's subsidiary recommendations and was under no compulsion to submit the appeal for decision at a higher level. The said recommendations were in effect gratuitous advice to the agency to which the requirements of Sec. 771.219 of the personnel regulations are inapplicable; (2) that the hearing examiner's restructuring of the agency's charges in his report recommending removal did not prejudice plaintiff or constitute reversible procedural error; (3) that the subsidiary recommendations of the examiner did not diminish the agency's removal case against plaintiff and it was not reversible error for the examiner or the Deputy Director not to consider a lesser penalty than removal in view of such recommendations; and (4) that plaintiff suffered no

Syllabus

redressable harm by reason of the agency warning notice following his telegram to the President criticizing his superiors, since the Civil Service Commission reviewing authorities refused to sustain this part of the charge against plaintiff. Plaintiff's motion for summary judgment is denied, defendant's cross-motion is granted, and the petition is dismissed.

Civilian pay; dismissal; regulation of executive department; necessity for compliance with.

[1] An agency's failure to abide by personnel regulations in adverse personnel actions will invalidate any action taken (*Service* v. *Dulles*, 354 U.S. 363 (1957)).

United States ⇐ 36

Civilian pay; dismissal; regulation of executive department; necessity for compliance with.

[2] The fact that the Deputy Director of the employing agency, in accepting the hearing examiner's recommendation that plaintiff be removed from his position, disregarded other gratuitous recommendations unrelated to the examiner's specific assignment to assess the agency's case for the proposed removal, was not a violation of Sec. 771.219 of the personnel regulations providing that the agency-authorized official either accept the examiner's reason-supported recommendations as to the agency's proposed disciplinary action or articulate his objections and submit the action to a higher level for decision, since only the examiner's recommendation respecting his assigned task was subject to the requirements of the regulation. Accordingly, in accepting the removal recommendation, the director was under no compulsion to submit the appeal for decision to a higher level.

United States ⇐ 36

Civilian pay; charges and reasons for dismissal.

[3] While deviations between an agency's putative charges for proposed adverse personnel action and the grounds advanced by a hearing examiner as supportive of the adverse action are not to be cavalierly tolerated, where the record is clear that the hearing examiner in restructuring the agency's charges in his report recommending plaintiff's removal neither prejudicially changed the agency's charges nor recommended removal on charges differing from those of the agency, the examiner's treatment of the charges did not constitute procedural error sufficient to warrant reversal of the agency's removal action.

United States ⇐ 36

Civilian pay; dismissal; arbitrary and capricious action; what constitutes.

[4] Where a hearing examiner sustained all the agency's removal charges, recommended plaintiff's removal from his position, and gratuitously recommended that plaintiff receive a retroactive within-grade raise and be paid for a 3-day suspension, since the

Opinion of the Court

agency did not rely on the fact that plaintiff had been denied a within-grade increase or that he had been suspended as reasons justifying removal, the examiner's actions in not considering a less severe penalty than removal were not arbitrary, unwarranted or capricious.

United States ⇐ 36

Civilian pay; administrative remedies; failure to exhaust.

[5] In general, a Government employee must exhaust his administrative remedies prior to bringing suit in this court based on loss of pay arising from an alleged adverse personnel action; this rule extends to the employee's failure to raise an alleged error by the hearing examiner and the Deputy Director in not considering a less severe penalty than removal.

United States ⇐ 39 (11)

Civilian pay; dismissal; charges and reasons for dismissal; reversible error, what constitutes.

[6] The agency's action in failing to grant plaintiff a hearing before issuing its warning letter respecting his action in telegraphing the President criticizing his superiors, an event the agency relied on in support of its removal charges, does not constitute reversible error where the Civil Service reviewing bodies did not sustain this part of the charges.

United States ⇐ 36

Benjamin Berman, attorney of record, for plaintiff.

Russell W. Koskinen, with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Before COWEN, *Chief Judge*, DURFEE, *Senior Judge*, and SKELTON, *Judge*.

DURFEE, *Senior Judge*, delivered the opinion of the court:

In this appeal we are asked to review the process by which plaintiff was removed from his career Civil Service position. Plaintiff, by way of motion for summary judgment, challenges only the how, and not the why, of his removal, and seeks back pay and position restoration. Defendant's cross-motion for summary judgment denies the existence of any procedural errors in plaintiff's removal, and seeks sustentation of the various administrative appellate decisions uniformly upholding plaintiff's removal.

As we are in agreement with defendant's position, its cross-motion for summary judgment is granted; plaintiff's motion is denied, and his petition dismissed.

Ismail A. Razik entered the Federal Civil Service in November 1967 as a Grade GS–10 Writer-Editor in the Publications Division of the United States Information Agency (hereafter USIA or Agency). He subsequently advanced to Grade GS–11 in 1969, received career tenure in 1970, and advanced again to Grade GS–12 in 1971. By change of occupation code, plaintiff was reclassified as a Foreign Information Specialist, Grade GS–12, in the Press and Publications Service, Publications Division, al-Majal Magazine Branch of the USIA in 1973.

Plaintiff's involvement in several disruptive incidents between September 1972 and May 1973 prompted the USIA to propose removal of plaintiff from his position. The Agency notified plaintiff on August 3, 1973 of its proposed action. The Agency's notice of proposed removal specifically charged plaintiff with "repeated uncooperative, obstructive, insubordinate behavior and intemperate language." This notice detailed specific incidents supportive of the Agency's charges, and advised plaintiff of his appeal rights. Plaintiff responded in writing to the Agency's letter of charges on August 13, 1973. In his reply, plaintiff largely admitted the occurrence of the events leading to the Agency's proposed removal of plaintiff. In his written response, plaintiff offered mitigating explanations of his actions, and requested the USIA to reconsider and abandon its removal proposal. On August 21, 1973, the Agency notified plaintiff that, after full consideration of the written response, the Agency considered that its charges were supported by the evidence and warranted plaintiff's removal. The Agency's letter set September 7, 1973 as the effective date of plaintiff's removal, and again advised plaintiff of his appeal rights. Following receipt of this letter, plaintiff initiated an intra-agency appeal, and requested a hearing. The USIA afforded plaintiff an evidentiary-type hearing before a qualified State Department Hearing Examiner, and extended plaintiff's removal date.

In a letter report to the Agency the Hearing Examiner found "the Government's arguments convincing and supportive of the charges" and "recommended that the Agency proceed to remove Mr. Razik from his position." In assessing

the Agency's case against plaintiff, the Hearing Examiner broke down the Agency's charge of "repeated uncooperative, obstructive, insubordinate behavior and intemperate language" to:

> "Charge 1—Uncooperative and Obstructive behavior.
>
> * * * * *
>
> Charge 2—Insubordinate behavior.
>
> * * * * *
>
> Charge 3—Intemperate language.
>
> * * * * *"

Under each of the enumerated charges the Hearing Examiner cited evidence from the hearing record supportive of the charges. As to plaintiff's case, the Examiner saw "no reason, cultural or other for [plaintiff's] subsequent thoroughly immature behavior."

In addition to recommending that the Agency proceed with plaintiff's removal, the Hearing Examiner went on to make two further recommendations. The Examiner recommended that the Agency retroactively grant plaintiff a within grade increase previously withheld, and repay plaintiff for a previous three-day suspension. The Hearing Examiner recommended these latter two courses of action to undo what the Examiner considered to be overriding procedural flaws in the Agency's execution of those disciplinary measures. Neither the denial of the within grade increase nor the suspension were facts relied on by the Agency to substantiate its removal case against plaintiff.

The USIA's Deputy Director accepted the Examiner's removal recommendation, and notified plaintiff by letter on December 6, 1973 of his removal, effective at the close of business on the following day to promote the efficiency of the Federal service. The Agency's Deputy Director disregarded the Hearing Examiner's latter two recommendations because, as he informed plaintiff:

> [The Hearing Examiner's] duties under Sections 771.209 and 771.213 of the regulations are limited solely to matters relating to the Agency's decision to remove you from your position. The denial of your within-grade [increase] and your three-day suspension are not "reasons" for your removal, nor are they a part of the present appeal. Accordingly, they cannot, and did not become a part of his conclusions as to the necessity of your removal.

Plaintiff initiated a timely appeal of the USIA's removal decision to the Civil Service Commission's Appeals Examining Office on December 10, 1973. That office on review of the Agency's decision, while not sustaining in all respects the elements of the USIA's charges, found that the Agency had complied with the procedural requirements of the law and the regulations in effecting plaintiff's removal, and that the Agency's removal action was based on sustained charges, and was not arbitrary, unreasonable or capricious.

Plaintiff pursued a further appeal of the Civil Service Commission's Appeals Examining Office's decision to the Civil Service Commission's Appeals Review Board. On careful review of the entire record, that Board, while disagreeing with some of the Hearing Examiner's actions in the case, and some of the Appeals Examining Office's review conclusions, concurred with the Appeals Examining Office's determination that the Agency had complied with all mandatory procedural requirements in effecting plaintiff's removal, and affirmed the Appeals Examining Office's determination that plaintiff's removal was for such cause as would promote the efficiency of the Federal service.

Plaintiff brought a timely appeal to this court for review of the administrative actions culminating in his removal from the Federal service. In pressing his appeal, plaintiff contends that his removal is invalid on two broad grounds. Plaintiff argues *one*, that the USIA's failure to follow both Civil Service Commission and its own regulations, invalidates his removal. *Second*, plaintiff asserts that the various review decisions upholding his removal were arbitrary, unwarranted and capricious as to nullify his removal. Under these two charges, plaintiff lists six specific procedural errors.

Plaintiff's prime argument is that the USIA's Deputy Director violated certain personnel regulations in making the appellate decision accepting the Hearing Examiner's removal recommendation, but disregarding the Examiner's other two recommendations. For this argument, plaintiff relies on Civil Service Commission Regulation section 771.219 (5 C.F.R. 771.219 (1973)), and section 566.5 of the USIA's Manual of Operations and Administration.

Civil Service Commission Regulation section 771.219 specifies:

> Sec. 771.219 Appellate decision. (a) When a hearing was not held before the appellate decision, the authorized official shall consider the appeal file and make an appellate decision on the basis thereof. (b) When a hearing was held before the appellate decision, the authorized official shall accept the examiner's recommendations and issue the appellate decision, except that:
>
> (1) If the head of the agency is to decide the appeal, he shall consider the appeal file and make the appellate decision on the basis thereof.
>
> (2) If the authorized official desires to take a less severe action than that recommended by the examiner, he shall make the appellate decision accordingly, without regard to the examiner's recommendation.
>
> (3) *If the authorized official determines that the examiner's recommendations are unacceptable, he shall transmit the appeal file with a specific statement of the basis for that determination to a higher level of authority, designated by the agency, for decision.* [Emphasis added].

* * * * *

Section 566.5(b)(2) of the USIA Manual of Operations and Administration designates the Agency's Deputy Director as the authorized official to make the appellate decision under Civil Service Commission Regulation section 771.219. Section 566.5 of the USIA Manual of Operations and Administration provides:

> 566.5 *Appellate Decision Process and Time Standards in Event of Deputy Director's Absence*—If the Deputy Director is not in Washington when the appeals examiner completes his report, it will be submitted to the Director. The Director:
>
> a. Makes the appellate review and decision in accordance with 771.218 and 771.219(b)(1) of the Regulations, or
>
> b. In accordance with Section 771.218(a) of the Regulations, designates an Agency official to make the apellate review and decision.
>
> (1). The designated official makes the appellate review and, within ten calendar days following the date he receives the appeals examiner's report, makes the applellate decision or refers the appeal to the Director in accordance with Section 771.219(b)(3) of the Regulations.

(2). *The Director decides an appeal referred to him under section 771.219(b)(3) of the Regulations within ten calendar days of the date that he receives the appeal file.* [Emphasis added].

Plaintiff maintains that the USIA Deputy Director's action in accepting only the Examiner's removal recommendation, violated the above regulations. Plaintiff contends that since the Deputy Director rejected two of the Examiner's recommendations he was required to submit the proposed agency removal action to the USIA Director for decision, and the Director was required to render an appellate decision within ten days.

The failure of the USIA's top management personnel to comply with these regulations, plaintiff argues, invalidates his removal. Plaintiff correctly asserts that an agency's failure to abide by personnel regulations in adverse personnel actions will invalidate any action taken. *Service* v. *Dulles*, 354 U.S. 363 (1957). However, in our view the USIA Deputy Director's appellate decision to implement the Hearing Examiner's recommendation to remove plaintiff while rejecting the Examiner's additional recommendations, transgressed neither the letter nor the spirit of the applicable personnel regulations. *Conn* v. *United States*, 180 Ct. Cl. 120, 376 F. 2d 878 (1967).

Section 771.219 of the Civil Service Commission Regulations guides the processes by which an agency effectuates serious adverse disciplinary actions against a Federal employee. Section 771.202 of the same regulations limits the applicability of the section 771.219 requirement to only the serious disciplinary actions of removal, suspension of more than thirty days, furlough without pay and reduction in rank or pay. Section 771.219 requires that when, after consideration and written report by a qualified impartial hearing examiner on an agency's proposed adverse personnel action, the authorized agency official who is to make the implementing appellate decision on that action disagrees with the examiner's recommendations, that official must forward the appeal file with an explanation of his disagreement to a higher authority for decision. The theoretical and practical reasons for such a procedure are obvious.

Opinion of the Court

The hearing examiner's written recommendations and findings regarding a serious adverse agency personnel action are submitted after a hearing comporting with all essential due process protections and the hearing examiner's consideration of all the arguments and evidence presented by the parties. Recommendations born of such labor are not lightly to be disregarded. The requirement that an authorized agency official, below the top level of agency management, cannot take action contrary to an examiner's considered and justified recommendations, assures the subject of proposed serious disciplinary action thorough and reasoned attention of his case, and guarantees the integrity of a merit civil service. This requirement also assures that the recommendations and conclusions of an impartial hearing examiner formulated after hearing and consideration of the parties' respective cases cannot be vitiated by an agency official biased by involvement in the agency's presentation of its adverse personnel action against an employee. The vitalness and necessity of such a requirement are readily apparent.

Civil Service Commission Regulation section 771.219 requires, as a protection to a Federal employee subject to serious adverse disciplinary action, that the agency-authorized official either accept the hearing examiner's reason-supported recommendations as to the agency's proposed disciplinary action or articulate his objections, and submit the action to a higher level for decision. This section does not require that the authorized agency official agree with *any* recommendation a hearing examiner may include in his report.

In presenting its case against plaintiff to the Hearing Examiner, the Agency sought to test only the validity of its proposed removal determination. In the presentation of its case to the Hearing Examiner, the Agency did not seek to test the validity of its prior actions in withholding plaintiff's within-grade increase or plaintiff's three-day suspension. Nor was plaintiff in opposing the Agency's proposed removal action, appealing the validity of these prior disciplinary actions. The Agency's letter of charges, the Examiner's letter report and the hearing transcript amply indicate that the Hearing Examiner's assignment was the assessment of the

Agency's case for proposed removal of plaintiff. Only the Hearing Examiner's recommendations on this issue are subject to the requirements of Civil Service Regulations section 771.219. Both of the other matters which the Hearing Examiner chose to comment on in his recommendation letter were extraneous to this removal issue. The fact that the Examiner set out his recommendations on these matters as separate enumerated parts of his report rather than include them as part of his removal recommendation, demonstrates that the Examiner considered them separate and apart from the removal issue.

Both the Hearing Examiner and the USIA Deputy Director were engaged in a process to decide on plaintiff's removal, and not the correctness of the Agency's actions regarding the within-grade increase or suspension. The requirements of section 771.219 of the Civil Service Regulations apply only to the Agency's chief action—plaintiff's removal. The Hearing Examiner's additional recommendations, unrelated to this chief issue, were in effect gratuitous advice to the Agency to which the requirements of section 771. 219 are inapplicable. Further, section 771.202 of the Civil Service Regulations does not even subject the Agency actions of withholding within-grade increases or three-day suspensions to the requirements of section 771.219.

As the Hearing Examiner's two additional recommendations were unrelated to his assignment, assessment of the Agency's case for plaintiff's removal, the USIA Deputy Director committed no procedural error in excluding these from the case and, as the Agency Deputy Director agreed with the Hearing Examiner's removal recommendation, he was under no compulsion to submit the appeal for decision at a higher level. The court has carefully considered all of the cases listed *seriatim* in plaintiff's brief without pointed analysis, and finds none of them cogently supportive of plaintiff's position.

Plaintiff's second specification of error concerns the Hearing Examiner's refinement of the Agency's charge against plaintiff. Plaintiff asserts that the Examiner's recasting of the Agency's single "broad-brush" charge against plaintiff contained in the Agency's letter of charges to the three

enumerated charges set forth in the Examiner's recommendation letter, denied plaintiff "a fair, objective and impartial evaluation by the hearing officer of the Agency's case against him." *Pltf's Mo. p. 4.*

The Civil Service Commission's Appeals Review Board agreed, albeit without explanation, with plaintiff's contention that the Hearing Examiner in his recommendation letter improperly broke down and reconstructed the Agency's charge as set forth in the Agency's letter of charges. However, the Board could find no prejudicial error adverse to plaintiff in this action. We concur in this view.

The Agency's single sentence charge against plaintiff descriptively capsulizes with adequate specificity the events detailed in its charge letter as justifying the Agency's proposed removal action. The Agency's letter of charges sets out with sufficient specificity the events for which the Agency proposed to remove plaintiff. It was these events specified by the Agency rather than the summary charge that the Examiner considered in assessing the Agency's case against plaintiff.

While the Hearing Examiner broke down the Agency's single charge against plaintiff the Examiner did consider each of the events cited by the Agency in support of its proposed removal action.

In assessing the Agency's case for plaintiff's removal, the Hearing Examiner sustained the same charges of misconduct that were contained in the Agency's letter of charges to plaintiff. The Examiner's report recommending plaintiff's removal dealt with each of the events relied on by the Agency as justifying plaintiff's removal, and neither prejudicially changed the Agency's charges nor recommended removal on different charges than those contained in the Agency's letter of charges.

Deviations between an agency's putative charges for proposed adverse personnel actions and the grounds advanced by a hearing examiner as supportive of the adverse personnel action, are not to be cavalierly tolerated, and often flag a procedurally improper personnel action.

In this case, however, the record is clear that plaintiff was removed on substantiation of the same charges of miscon-

duct as set forth in the USIA's letter of proposed removal. As such, it cannot be said that the Hearing Examiner's restructuring of the Agency's charges in his report recommending removal either prejudiced plaintiff, or constituted reversible procedural error sufficient to warrant reversal of the Agency's removal action.

In two separate arguments, plaintiff accused both the Hearing Examiner and the USIA Deputy Director of arbitrary, unwarranted and capricious conduct in not considering a less severe penalty than removal. Plaintiff's argument is that as the Hearing Examiner made two recommendations in plaintiff's favor, *viz:* retroactive payment of plaintiff's previously withheld within-grade increase and restoration of suspension pay, plaintiff is thus less guilty than originally charged, and should have received a less severe penalty than removal. In raising this argument, plaintiff mistakenly asserts that the Hearing Examiner's two recommendations in plaintiff's favor "washed out" of the record part of the Agency's case against plaintiff. In point of fact, however, neither the Hearing Examiner in making his removal recommendation nor the USIA Deputy Director in accepting that recommendation relied on the facts that plaintiff was denied a within-grade increase or suspended as grounds warranting plaintiff's removal.

In presenting its removal case against plaintiff, the Agency did not rely on the fact that plaintiff had been denied a within-grade increase or the fact that plaintiff had been suspended as reasons justifying plaintiff's removal. Hence, the Hearing Examiner's recommendations that these actions be rectified only because of possible procedural errors did not diminish the Agency's removal case against plaintiff in any respect.

As the Hearing Examiner, in his recommendation letter, sustained all of the Agency's removal charges and rejected none, his actions in not considering a lesser penalty than removal, cannot be said to be arbitrary, unwarranted or capricious. Likewise, the USIA Deputy Director's acceptance of the Hearing Examiner's removal recommendation on the strength of the Examiner's letter report cannot be considered arbitrary, unwarranted or capricious. Plaintiff's

accusations of reversible error conduct on the part of the Hearing Examiner and USIA Deputy Director are based on an erroneous premise and must, for this reason, fail.

Even if the error in plaintiff's above arguments were not so patent, plaintiff's failure to present these arguments to Civil Service Commission's Appeals Review Board, would preclude the court from sustaining them on appeal. *Haynes v. United States*, 190 Ct. Cl. 9, 418 F. 2d 1380 (1969).

As his fifth alleged procedural error, plaintiff complains that the USIA's action in summarily issuing a warning letter to plaintiff for his action in transmitting to the President a telegram critical of his superiors, denied plaintiff due process of law. The Agency relied on this event as one of the items supporting one of the elements of its removal charge against plaintiff. The Hearing Examiner sustained this part of the Agency's removal charge. On review, however, the Civil Service Commission's Appeals Examining Office refused to sustain this part of the Agency's charge against plaintiff. The Civil Service Commission's Appeals Review Board affirmed this position.

Plaintiff understandably supports the decisions of the Civil Service Commission's review bodies in not sustaining this part of the Agency's removal charge. However, plaintiff contends that the Agency's failure to accord plaintiff a hearing before issuing its warning letter, constitutes reversible error invalidating his removal. We find this position untenable.

As the Civil Service Commission's top review body vindicated plaintiff's right to petition the President for redress of grievances, and thereby blocked any possible disciplinary action on account of plaintiff's action, plaintiff has suffered no harm on account of his telegram.

Absent evidence that plaintiff has been aggrieved by Agency disciplinary action on account of his telegram to the President, plaintiff has suffered no redressable harm, and the Agency's action in failing to grant plaintiff a hearing before issuing its warning letter does not constitute error sufficient to warrant reversal of plaintiff's removal.

Finally, plaintiff attacks the decision of both the Civil Service Commission's Appeals Examining Office and Ap-

peals Review Board as arbitrary, unwarranted and capricious. Plaintiff's only basis for this charge is that these bodies condoned the alleged procedural errors discussed above. As the court could find no merit on individual consideration of plaintiff's preceding five specifications of procedural error, this last catch-all cumulative error argument must likewise be dismissed as meritless.

Since the administrative removal proceedings against plaintiff were free of procedural defects, and the decision to remove plaintiff was not arbitrary, unwarranted or capricious, plaintiff is not entitled to recover.

Defendant's cross-motion for summary judgment is granted. Plaintiff's motion for summary judgment is denied, and his petition is dismissed.

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525 F. 2d 1035

FRANK A. PELLICCIA, STATUTORY RECEIVER FOR STANDARD ELECTRONICS CORPORATION v. THE UNITED STATES

[No. 36–74. Decided November 19, 1975]

ON PLAINTIFF'S AND DEFENDANT'S MOTIONS FOR SUMMARY JUDGMENT

Contracts; default termination; failure to make delivery; waiver of performance date.—On June 25, 1969 plaintiff was awarded a fixed-price contract to fabricate and deliver within 60 days two television transmitters for use by the Armed Services in the Panama Canal Zone, the bid solicitation requiring bidders to furnish evidence of FCC "Type acceptance" of the bidder's proposed transmitting system. Attachment 1 to the specifications set forth the performance standards which were similar to those applicable to FCC type acceptance except respecting picture quality which were more strict. Because of performance difficulties attributable for the most part to delivery delays of needed parts and in securing adequate personnel, the parties agreed to an extension of the delivery date to October 23, 1969. Subsequently, upon mutual agreement providing for an increase in contract price but with no change in the October 23 delivery date, the contract was amended to require system testing, the tests being similar to those previously used by the Government except for addition of specially drafted "envelope delay" measurements specified in Attachment 1. By contract modification the delivery schedule was further extended to October 29, 1969, the extension having been verbally agreed to during prior negotiations.

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However, plaintiff failed to meet this date, alleging test equipment problems and interference by defendant's quality assurance representative and others, and requested an extension to November 18. On October 29 the contracting officer issued a "show cause" letter giving plaintiff 10 days within which to furnish facts excusing its failure to perform; plaintiff replied repeating its reasons for delay. The contract was default terminated on November 18, 1969, for failure to perform systems test by October 29. On appeal, the Board of Contract Appeals concluded that termination was proper because plaintiff's transmitters did not substantially conform to Attachment 1 specifications by October 29 and that defendant had not waived full compliance with those specifications. It is *held* (1) that the bilateral agreement of the parties, evidenced by formal contract modification, sufficiently established October 29 as the new delivery date; (2) that the inspections and other actions taken by defendant during the "show cause" period were not an inducement to plaintiff to continue performance, the inspections having been requested by plaintiff; (3) that the delay in terminating after issuance of the "show cause" letter did not constitute waiver of the October 29 delivery date since a reasonable time should be afforded a contractor to demonstrate that failure to deliver was excusable; (4) that defendant by failing to issue a formal quality deficiency report did not waive full compliance with the specifications or become estopped from claiming noncompliance therewith; and (5) that plaintiff has failed to establish that the decision of the Board was erroneous, arbitrary, capricious or unsupported by substantial evidence. Plaintiff's motion for summary judgment is denied, defendant's cross-motion is allowed, the petition is dismissed, and judgment is entered for defendant covering its excess costs of reprocurement of the transmitters in the stipulated amount of $13,400.

Contracts; waiver; breach of contract, waiver of.

[1] In a waiver after breach situation, time may again become essential and the Government may regain the right to terminate a delinquent contractor for default, if (1) the Government unilaterally issues a notice under the contract's default clause establishing a reasonable but specific time for performance on pain of default termination, or (2) the parties bilaterally agree upon a new delivery date. Whether waiver has taken place is governed by the circumstances of each case.

United States ⇦ 73(3)

Contracts; disputes; administrative findings; finality of in question of fact dispute.

[2] In a contract dispute the findings of the contract appeals board are conclusive and binding on this court where they are supported by substantial evidence.

United States ⇦ 73(15)

Contracts; performance; delay in delivery; show cause notice.

[3] Fairness to the contractor requires that the contracting officer

allow a reasonable time within which the contractor may endeavor to demonstrate that its failure to deliver was excusable. Even when the delay is found not to be excusable, the contracting officer should have a reasonable time within which to determine whether a default termination would be in the best interest of the Government as the nondefaulting party.

United States ⇐ 73(6, 26)

Contracts; performance; substantial performance; cure period.

[4] While a Government contractor is entitled to a cure period if the goods delivered are in substantial conformity with contract specifications, where the deviations are neither trivial nor inconsequential the Government is entitled to insist on full compliance with specifications on pain of default termination.

United States ⇐ 72(7)

Contracts; disputes; administrative decision; substantial evidence; conflicting testimony.

[5] In Wunderlich Act review of an administrative decision rendered in a contract dispute, although the record before the contract appeals board may contain conflicting expert testimony, this court does not weigh the evidence independently.

United States ⇐ 73(15)

Scott G. Rigby, attorney of record, for plaintiff. *King & King*, Chartered, of counsel.

John W. Showalter, with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Before DURFEE, *Senior Judge*, NICHOLS and KASHIWA, *Judges*.

PER CURIAM: This case comes before the court on plaintiff's* request, filed March 5, 1975, for review by the court of the recommended decision filed on February 19, 1975, by Trial Judge Fletcher, pursuant to Rules 166(e) and 54(b)(3) and on defendant's motion in response, filed April 4, 1975, to adopt said recommended decision. The case has been submitted to the court on the briefs of the parties and oral argument of counsel. Upon consideration thereof,

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*As is apparent from the caption, the nominal plaintiff in this case is Frank A. Pelliccia, who is a Statutory Receiver appointed by the Superior Court of New Jersey, Chancery Division, Monmouth County, Docket No. C-3284-70, for Standard Electronics Corporation. Herein the designation of "plaintiff" is given to the corporation which was the contractor involved in this dispute.

Per Curiam

since the court agrees with the said recommended decision, as hereinafter set forth, it hereby affirms and adopts the same as the basis for its judgment in this case.

Plaintiff argued before us that the trial judge's opinion ignored his contention that the delivery date at issue had been extended on October 22, 1969, by express bilateral oral agreement to an indefinite period to enable the contractor to perform additional tests. Plaintiff has failed to show the existence of any express agreement to extend the delivery date; at most, an agreement arose by implication only from agreements concerning future testing. However, plaintiff's subsequent conduct indicates that he did not rely on any alleged oral agreement made on October 22, 1969. Plaintiff's president signed an agreement on October 31, 1969, extending the delivery date to October 29, 1969. This agreement did not mention the alleged October 22, 1969, oral agreement and it is hardly possible that plaintiff would have signed the written agreement if an oral agreement extending the delivery date to an indefinite period already existed. On October 29, 1969, plaintiff wrote to the Procurement Contracting Officer (PCO) requesting an extension of the delivery date to November 18, 1969. The request would have been unnecessary if the parties had agreed on October 22, 1969, to extend the delivery date indefinitely. Moreover, plaintiff's response to the PCO's show cause letter, dated November 11, 1969, did not include any reference to the alleged October 22, 1969, agreement. The above factors negate plaintiff's argument that it relied on an express oral agreement to extend the delivery date which should supersede the written agreement signed by plaintiff on October 31, 1969.

Therefore, it is concluded that plaintiff is not entitled to recover and the petition is dismissed. The termination for default having been properly issued, judgment is entered for defendant covering its excess costs of procurement in the stipulated amount of $13,400.

The opinion and conclusion of law of the trial judge follow:

FLETCHER, *Trial Judge:* In this contract case, plaintiff challenges, pursuant to Wunderlich Act standards, 41 U.S.C.

§§ 321–22 (1970) the finality of an adverse decision by the Armed Services Board of Contract Appeals (ASBCA Nos. 14753 and 16299). As described by the Board:

> ASBCA No. 14753 is an appeal from the contracting officer's final decision dated 18 November 1969 terminating the above contract for default on the ground that appellant failed to satisfy the contract requirements by the delivery date, as amended. Appellant contends that by its course of conduct the Government waived the delivery date on which the termination was based, and, further, that by the time of termination appellant had completed or substantially completed all of the contract requirements.
>
> ASBCA No. 16299 is an appeal from the contracting officer's final decision dated 2 April 1971 determining that appellant is liable to the Government under the above contract for $15,965.93 representing excess costs of reprocurement. Appellant does not challenge the excess cost assessment on grounds other than the alleged impropriety of the default termination. The quantum of excess costs assessed has become the subject of a stipulation discussed *infra*.[1]

From a careful consideration of the administrative record, it is concluded for reasons hereinafter stated that the Board's decision in ASBCA No. 14753 is supported by substantial evidence and is correct as a matter of law. Accordingly, plaintiff's motion for summary judgment is denied, and defendant's cross-motion is allowed. Plaintiff's petition is dismissed, and judgment entered for defendant on its counterclaim for $13,400.

Plaintiff, an experienced builder of television transmitters, was the successful bidder in responding to a solicitation for bids by the Sacramento Army Depot (SAAD) covering the fabrication and delivery of two television transmitters for broadcast over Channels 8 and 10, respectively. The Army intended to use the two transmitters in the Panama Canal

[1] The nearly $16,000 of excess cost of reprocurement, as asserted by the contracting officer, was later reduced by stipulation of the parties during the Board hearing to the figure of $13,400. On the basis of such stipulation, the Board concluded that plaintiff was liable to the Government in the stipulated amount of $13,400 "plus interest thereon". Defendant has counterclaimed for said stipulated amount and, since plaintiff has filed no reply to the counterclaim, it may properly be assumed that the stipulation as to quantum only remains viable in this proceeding.

Zone as part of the Armed Forces Radio and Television (AFRT) system, and in keeping with a policy of assuring local governments that AFRT stations would not interfere with local transmitting and receiving activities, the solicitation leading to award of the contract required bidders to furnish evidence of Federal Communications Commission (FCC) "type acceptance" of the bidder's proposed transmitter system. After some initial confusion over whether an existing type acceptance applied to plaintiff's particular equipment, the FCC advised the Army that plaintiff's transmitter had not been type accepted. Apparently, however, the plaintiff did not anticipate any difficulty in obtaining FCC acceptance, and the contract, as awarded to plaintiff on June 25, 1969, was based on the mutual understanding that FCC type acceptance had to be obtained by plaintiff before the Government would accept the transmitters.

The contract required delivery of both transmitters within 60 days from the date of award and in its General Provisions incorporated by reference the clauses contained in Standard Form 32, including the standard Default Clause for fixed supply contracts. In addition, the contract included as Attachment 1 specifications prescribing electronic characteristics with allowable tolerances. The performance standards set forth in Attachment 1 (which were derived from an earlier industry association publication) were similar to those applicable to FCC type acceptance except in the area of picture quality where the Attachment 1 standards were somewhat more strict.

From the very beginning, plaintiff experienced performance difficulties attributable for the most part to delivery delays of needed parts and in securing adequate personnel. Following the expiration of the prescribed delivery date, the Administrative Contracting Officer (ACO) issued a so-called "show cause" letter [2] inviting plaintiff to present any excuses it might have for its failure to deliver. Plaintiff's response appears to have satisfied the Government, for instead of a threatened default termination, the Government agreed to a contract modification (A001) extending the de-

[2] About two weeks previously, the ACO had issued a ten-day "cure" notice.

livery date to October 23, 1969, in return for a reduction in the contract price.

As originally awarded, the contract contained no "proof of performance" testing requirements for the transmitters although such testing is a normal FCC requirement in standard commercial sales. Upon learning of this omission, AFRT requested the procuring agency to obtain an amendment requiring system testing. Negotiations followed during which plaintiff's president indicated willingness to perform the desired testing with no change in the October 23 delivery date and would engage the services of a Washington, D.C. firm of consulting engineers for assistance in conducting the desired tests. The parties also agreed to an increase in the contract price, and Modification A002 amended the contract accordingly as of October 9, 1969. A form listing and identifying the performance tests to be conducted was incorporated into the contract as Attachment 2, which was similar to those previously used by the Government except for the addition of a specially-drafted page covering "envelope delay" measurements as specified in Attachment 1.

On October 10, Mr. Wilner, a member of the engineering firm retained by plaintiff, arrived at the plant, and meetings were held to discuss system test procedures and equipment. Except for station monitors needed to conduct FM noise tests, plaintiff possessed all necessary testing equipment, and testing procedures were commenced on October 13.

Mr. Wilner discovered that the testing requirements for FCC type acceptance were identical to the requirements of Attachments 1 and 2, except for two or three areas in Attachment 1. Accordingly, he informed all concerned that he would test initially to FCC performance parameters and thereafter seek to comply with the few more stringent requirements of Attachment 1 if time allowed. The Government representatives appeared to have no objection to Wilner's plan. However, plaintiff's president had assured them that final test data would show full compliance with the contract attachments, and the Board properly found that plaintiff recognized its contractual obligation to demonstrate compliance with all the performance requirements of Attachment 1. It was further found that, so long as the contract requirements

were ultimately satisfied, the Government representatives had no particular concern as to isolated deficiencies which might be shown by test results at various times.

Despite delays incident to "debugging" and obtaining station monitor equipment, by October 21 the Channel 8 transmitter had been operated as an entire system in compliance with the requirements of Attachment 2; the same was true of the Channel 10 transmitter although those tests were not completed until November 7. However, certain of the performance requirements of Attachment 1 were never satisfied.

Meanwhile, the delivery schedule was further extended to October 29, 1969, by Contract Modification A003, formally signed by plaintiff's president on October 31. This extension had been verbally agreed to during prior negotiations and apparently came about by reason of a six-day delay incurred by the Government in obtaining funds for the system testing prescribed by Modification A002.

Plaintiff wrote the PCO on October 28 stating that its delays were primarily due to difficulties in obtaining proper test equipment, to breakdowns of test equipment, and to interference by the Government's Quality Assurance Representative (QAR) and an observer from the Canal Zone using agency. With regard to the alleged Government interference, however, plaintiff's own consulting engineer did not agree since he felt that the QAR had been exceptionally helpful in all of the testing. The Board accordingly could find no support for plaintiff's allegations of Government interference during testing.

On the extended delivery date, October 29, 1969, plaintiff wrote a letter to the PCO requesting a further extension of the completion date to November 18, 1969 "to enable us to complete the Contract Amendment #1 Tests, and the packing of the equipment." On the same date, plaintiff advised the ACO by letter that the remaining Attachment #1 Tests would be done concurrently with FCC tests and continued to "satisfactory completion" within two weeks.

These October 29 letters from plaintiff crossed in the mails a "show cause" letter of the same date issued by the PCO in which plaintiff was invited to state within ten days any facts which might indicate that failure to perform arose out of

causes beyond its control. The "show cause" letter included the standard paragraph stating that:

> Any assistance rendered to you on this contract or acceptance by the Government of delinquent goods or services hereunder, will be solely for the purpose of mitigating damages, and is not to be construed as an intention on the part of the Government to condone any delinquency, or as a waiver of any rights the Government may have under subject contract.

Plaintiff received the "show cause" letter on November 3, 1969, and replied by letter to the PCO dated November 11, 1969. In that letter plaintiff reiterated that the delays were caused by test equipment problems and interference by Government personnel, and confirmed its request for an extension of the delivery date to November 18, 1969.

Meanwhile, testing had continued under Wilner's supervision. The expert assigned to advise the QAR, however, was recalled to Sacramento by the PCO, and a successor expert was appointed. The PCO notified plaintiff of this change by letter dated November 6, stating that the successor expert had been "designated for the life of the contract," that his authority was limited in the same way as his predecessor's, and, by follow-up telegram, that the substitution was not to be regarded as a waiver of any Government rights. The new expert arrived at plaintiff's plant on November 8, at which time the only Attachment 2 test remaining to be performed was the FM noise test on Channel 8.

On November 4, 1969, with almost all testing completed, Wilner returned to his Washington office to prepare the type acceptance report which plaintiff had not yet filed with FCC, and plaintiff advised both the PCO and the ACO that, except for the FM noise test, all tests on both transmitting systems had been "completed satisfactorily."

The advisor to QAR did not agree. He reported to the PCO on November 14 that certain performance requirements of Attachment 1 were not satisfied and that the equipment had not been tested as a system with all major components operated at the rated power input. Shortly prior thereto, several quality deficiency reports (QDR's) had been issued by the QAR relating to mechanical and visual discrepancies as dis-

tinguished from electrical operation or performance considerations, and these deficiencies were quickly corrected by plaintiff. Whereupon, plaintiff sent a telegram to the PCO stating that, despite the favorable reports of its consulting engineers, the QAR refused to sign the acceptance papers and that plaintiff was proceeding to comply with the revised packaging and shipping inspection requirements and would be "ready to deliver 18 Nov. 69." By another telegram to the PCO on November 17, plaintiff advised that the transmitters were packed and ready for shipment.

This was done despite the fact that neither the QAR or any other authorized representative had accepted the transmitters on behalf of the Government, or indeed had even authorized their transfer to the packaging company. The plaintiff's action was apparently based on its assumption that FCC type acceptance and SAAD approval of the proof of performance test results were imminent. Actually, however, the FCC type acceptance, application for which was not filed by plaintiff until November 10, was not forthcoming until several days after the default termination on November 18. SAAD never accepted the adequacy of the test results on the ground that neither transmitter met the Attachment 1 performance requirements with respect to amplitude versus frequency characteristics, envelope delay versus frequency characteristics, and power consumption. As the Board found, on substantial evidence, plaintiff succeeded (albeit tardily) in satisfying the FCC type acceptance requirements but did not satisfy the stricter requirements contained in Attachment 1. Plaintiff's own consulting engineer agreed that this was true, but stated that by making relatively minor adjustments he could have satisfied the Attachment 1 criteria. He did not undertake to do so, however, because of his at that time single-minded concentration on satisfying the less stringent FCC type acceptance requirements. He adopted this approach because of his belief that the ACO was interested only in meeting the FCC specifications. Concerning the testing between November 3 and November 7, Mr. Wilner's report states:

> It should be pointed out that as soon as we met the FCC requirements, we stopped because of the laborious, time

> consuming effort that it required. Undoubtedly, this could have been improved if we had more time. (By this time, the specter of not meeting the delivery date was so great that we just did not feel justified in trying to better the above results. [The ACO], also sensing this, told us to concentrate on meeting the FCC specs and not the Army's which was tighter in many areas.)

The Board was confronted with conflicting testimony on this factual issue of whether the ACO had waived full compliance with Attachment 1 requirements. In resolving the conflict, the Board found that the ACO did indeed concur in Wilner's efforts to expedite those tests necessary for FCC type acceptance whether or not they showed compliance with Attachment 1. But the Board went on to find:

> In none of this [letters and telegrams exchanged between the parties during the period, October 29 to November 15] does there appear any mention of an understanding on appellant's part that it was not obligated to comply with Attachment 1 performance requirements to the extent they were more stringent than the comparable FCC type acceptance requirements. On a matter of this importance it is difficult to understand why appellant did not verify such an understanding in writing if it in fact existed. The correspondence generated by appellant indicates, on the contrary, that appellant recognized that completion of contract performance required compliance with the Attachment 1 requirements.

The PCO terminated plaintiff's contract for default by telegram dated November 18, 1969. The reasons for termination were explained in a final decision letter of the same date in which the PCO stated:

> b. It was determined to terminate your contract for default for failure to effect timely delivery; failure to have FCC Type Acceptance, and failure to perform Systems test by 29 October 1969.

Thereafter, SAAD decided to reprocure the transmitters and to that end sent out bid solicitations containing the same terms and conditions as those in plaintiff's contract except for the addition of a written definition of the term "system test."

Meanwhile, plaintiff was endeavoring to upset the PCO's default termination and (1) offered to rerun the system tests

provided the Government would bear an estimated cost for retesting of around $30,500, or, (2) to ship the transmitters to the Canal Zone, install them, and prepare for testing there. After preliminary negotiations which culminated in a meeting in the office of the Procurement Director for Army Material Command on July 23, 1970, both of plaintiff's proposals were rejected.

As might be expected, reasons for the default termination were also discussed at this meeting, particularly the contentions of Government representatives that plaintiff's "piecemeal" testing did not constitute a "system" test and that plaintiff, despite its full recognition of a contractual obligation to demonstrate compliance with all Attachment 1 requirements, had failed to do so in several respects. While admitting such failure, plaintiff's consulting engineers testified before the Board to the effect that, until the meeting of July 23, they had been under the impression that the sole reason for termination was plaintiff's failure to meet the delivery date uncomplicated by any technical deficiencies. They considered the nonconformities to be insignificant and easily correctible in a relatively short time. The Board, however, on an extensive analysis of the expert testimony was unable to agree that the deficiencies were trivial or inconsequential and properly concluded that plaintiff's transmitters did not substantially conform to the Attachment 1 specifications. Nor, in the Board's view of the evidence, had the Government ever waived full compliance with those specifications.

Shortly after the meeting of July 23, the contracting officer was given authority to award a reprocurement contract and, as low bidder, RCA Corporation was awarded the contract on July 27, 1970. Following RCA's successful completion of the reprocurement contract, the contracting officer demanded from plaintiff nearly $16,000 as excess costs of reprocurement. The parties have stipulated, however, that if plaintiff is liable for such excess costs, the reasonable amount thereof is $13,400, and defendant has counterclaimed here for that amount. See footnote 1, *supra*.

From the foregoing, it is clear that plaintiff never substantially complied with all the contract requirements. It is also

clear that the administration of the contract by defendant's representatives can hardly be described as adroit. For example, eight days after the issuance of a "show cause" letter, the PCO "designated for the life of the contract" a new expert to furnish technical assistance and guidance to the QAR. It is not unreasonable to interpret this action as evidencing the PCO's belief that the contract remained in full force and effect notwithstanding plaintiff's failure to deliver on October 29, 1969. From all the evidence before it, however, the Board was "unable to conclude that the Government manifested to appellant that time was not of the essence or otherwise induced appellant to continue performance in reliance upon the Government's failure to terminate."

Whether the Board's inability to conclude otherwise was justified requires reference to the guidelines developed by this court concerning waiver by the Government of its right to terminate a contract where the contractor has failed to meet the contract delivery date. See, for example, *DeVito* v. *United States*, 188 Ct. Cl. 979, 413 F. 2d 1147 (1969) and the court's most recent decision in this area, *International Telephone & Telegraph Corp.* v. *United States*, 206 Ct. Cl. 37, 509 F. 2d 541 (1975).

In the latter case, the court summarized the waiver after breach doctrine at pp. 49–50, 509 F. 2d at 547–48, as follows:

> Under the *DeVito* rule, in a waiver after breach situation, time may again become essential and the Government may regain the right to terminate a delinquent contractor for default, if (1) the Government unilaterally issues a notice under the contract's Default clause establishing a reasonable but specific time for performance on pain of default termination, or (2) the parties bilaterally agree upon a new delivery date.

Insofar as applicable to the law of Government contracts, the doctrine thus succinctly summarized by the court appears to have been first articulated fully in Cuneo, *Waiver of the Due Date in Government Contracts*, 43 Va. L. Rev. 1, (1957). There, upon an extensive analysis of common law contract principles developed by early state court decisions

in private contract litigation, the author concludes as follows at pp. 29–30:

> Whether an election [waiver] has taken place will be governed by the circumstances of each case. The answer depends on whether the conduct of the Government agents reasonably indicates a manifestation of intention to permit continuation of performance. If such manifestation is given and the contractor acts accordingly, an election is made and time is no longer of the essence. Then, for the Government to require performance within a stated period, it must give notice to that effect. This period must be reasonable under circumstances existing at the time of giving the notice. If performance is not completed within this period, the Government has the right to terminate the contract for default.

A rational application of these principles to the facts presented here requires rejection of plaintiff's major contention that the Government by its actions waived the final established delivery date of October 29, 1969, so as to lose its right to terminate for default. While plaintiff's reliance on the *DeVito* decision as support for its contention is readily understandable, the case differs materially from the present one. The court's rejection of the default termination involved in *DeVito* was heavily influenced by the fact that at no time during the 48-day period between the contractor's failure to fulfill an installment delivery requirement and his receipt of the formal notice of termination, did he have any inkling that the contracting officer was thinking in terms of a termination for default. This total unawareness, coupled with the contractor's concerted and productive performance efforts during the same period—efforts made with the knowledge that the contracting officer was fully cognizant of them, was deemed sufficient to permit the contractor reasonably to infer that the Government had elected not to terminate on account of his failure to meet the first installment delivery requirement of the contract. 188 Ct. Cl. at 989, 991, 413 F. 2d at 1153–54.

As revealed by the Board's detailed analysis of the contracting officer's actions and admonitions to plaintiff here and its account of the background circumstances attending

those actions and expressions, the record in the instant case affords no rational basis for concluding that the plaintiff could have failed to recognize that a default termination was very much in contemplation. Plaintiff's expert was clearly disturbed by the probability of a default termination, and the PCO's "show cause" letter was issued immediately on plaintiff's failure to deliver on October 29. Equally remote from the situation that obtained in *DeVito* is the comparative insubstantiality of this contractor's performance efforts and the limited extent of his consequent tangible progress, as found by the Board, during the period between passage of the delivery date and the issuance of the default notice. Essentially, all that occurred during this period were plaintiff's efforts to obtain FCC approval and testing of the transmitters to show compliance with the contract specifications. While the FCC approval was eventually forthcoming, the tests regarding the more stringent contract requirements were never successful. Since the Board's factual determinations in this regard are supported by substantial evidence, they are conclusive here. Given those underlying determinations, it cannot be said that it erred in concluding that a waiver did not occur. Certainly that conclusion is not at odds with this court's holding in *DeVito*.

Nor is the *International Telephone & Telegraph* case any comfort to plaintiff. As shown by the above quotation from the opinion in that case, the court fully recognizes that time remains of the essence where both parties to the contract "bilaterally agree upon a new delivery date." The *unilateral* action of the Government there was insufficient to establish a new delivery date whereas here the *bilateral* supplemental agreement of the parties is evidenced by Modification A003 which sufficiently established October 29, 1969, as the new delivery date. Plaintiff's admitted failure to meet that new delivery date does not mean, as plaintiff would seem to imply, that upon such failure the contracting officer must instantly terminate the contract for default on pain of waiving the right to do so. Fairness to the contractor requires that

the contracting officer allow a reasonable time within which the contractor may endeavor to demonstrate that its failure to deliver was excusable. Even when the delay is found not to be excusable, the contracting officer should have a reasonable time within which to determine whether a default termination would be in the best interest of the Government as the nondefaulting party. Obviously these considerations prompted the issuance by the PCO of the October 29 "show cause" letter inviting plaintiff to state within ten days any facts which might indicate that its failure to perform arose out of causes beyond its control and advising that:

> Any assistance rendered to you on this contract or acceptance by the Government of delinquent goods or services hereunder, will be solely for the purpose of mitigating damages, and is not to be construed as an intention on the part of the Government to condone any delinquency, or as a waiver of any rights the Government may have under subject contract.

In its summary description and analysis of the actions taken by the Government representatives at plaintiff's plant during the "show cause" period, the Board stated:

> Moreover, we are unable to conclude that the inspections and other actions taken by the QAR represented an inducement to continue performance. As found above these inspections were requested by appellant. Had the QAR refused to perform them the Government might have been charged with interference with appellant's efforts to complete performance. Although the QAR issued QDR's requiring corrective action the work involved was minor and did not relate to the performance testing, which was the major cause of delay. Following appellant's correction of the deficiencies noted on the QDR's the QAR found the transmitters acceptable from a mechanical and visual standpoint, but he informed appellant at the same time (13–14 November 1969) that the transmitters could not be accepted until the FCC type acceptance was received and appellant's proof of performance test results were evaluated. As found above appellant did not file its type acceptance application until 10 November 1969 and did not mail its final proof of performance test reports until 17 November 1969. There is no evidence that appellant was advised that termination would be withheld pending action by the

> FCC or evaluation of appellant's proof of performance test results. Under these circumstances appellant could not reasonably have regarded the QAR's inspections and other actions in the post-delivery date period as an indication that the Government no longer considered it to be in default for failure to meet the delivery date.

From the foregoing, it is clear that the Board did not err in holding that the Government had the right on November 18, 1969, to terminate the contract for default on the ground that plaintiff had failed to meet the October 29 delivery date.

Finally, consideration must be given to plaintiff's contention that, even though it was fully aware of its failure to meet all the specifications required by Attachment 1 of the contract, nonetheless, the Government by failing to issue a formal Quality Deficiency Report waived full compliance with the specifications, or in any event, became estopped from claiming noncompliance therewith. According to plaintiff, the admitted nonconformities were relatively insignificant and could have been rectified by a few simple adjustments. In support of this contention, plaintiff relies on this court's decision in *Radiation Technology, Inc.* v. *United States*, 177 Ct. Cl. 227, 366 F. 2d 1003 (1966) where it was held that a contractor is entitled to a reasonable period within which to cure a noncomformity provided the supplies shipped are in substantial conformity with the contract specifications.

The flaw in plaintiff's argument, of course, is its failure to accept the conclusiveness of the Board's finding that the admitted deviations, far from being trivial or inconsequential, were such as to justify a conclusory finding that plaintiff's transmitters did not substantially conform to the Attachment 1 specifications. It is true that the Board's record contains conflicting expert testimony in this regard but it is well established that in its review of an administrative record the court does not weigh the evidence independently. See, for example, *Phillips Construction Co., Inc.* v. *United States*, 179 Ct. Cl. 883 (1967) where it is observed at p. 890:

> It is true that the record contains evidence to the contrary from some of plaintiff's witnesses. But plain-

tiff goes much too far in asking, in effect, that this court make an independent evaluation of this conflicting evidence and reverse the Board on the ground that it should have believed one group of witnesses rather than another.

Plaintiff insists, however, that its expert was led by the ACO and QAR to believe that compliance with the FCC type acceptance requirements was the only performance criteria necessary to acceptance of the transmitters. Both Government witnesses denied that they had ever advised plaintiff's expert to forget about the Attachment 1 specifications which in several respects were more stringent than the FCC requirements. From all the evidence before it regarding the testing procedures, the most the Board could find was that the Government representatives had no objection to plaintiff's plan of proceeding whereby it would endeavor to meet the FCC requirements as the first order of business. The Board did not believe that from such concurrence the plaintiff could justifiably conclude that it had been relieved from its obligation to comply with Attachment 1 requirements as a significant part of its overall performance. There is substantial support in the record for the Board's conclusion.

Accordingly, there is no rational basis for finding either a waiver or an equitable estoppel, and the Government was entitled to insist on full compliance with the contract specifications. See, *H. L. C. & Associates Construction Co.* v. *United States*, 176 Ct. Cl. 285, 367 F. 2d 586 (1966) and *Farwell Co.* v. *United States*, 137 Ct. Cl. 832, 148 F. Supp. 947 (1957).

CONCLUSION

The plaintiff has failed to establish that the decision of the Armed Services Board of Contract Appeals was legally erroneous, arbitrary, capricious, or unsupported by substantial evidence. Accordingly, plaintiff's motion for summary judgment is denied, the defendant's cross-motion for summary judgment is allowed, and plaintiff's petition dismissed. The termination for default having been properly issued, judgment is entered for defendant covering its excess costs of procurement in the stipulated amount of $13,400.

Syllabus

525 F. 2d 1046

LYNN L. CHARLSON AND BERYL W. CHARLSON v. THE UNITED STATES

[No. 176-71. Decided November 19, 1975]

ON THE PROOFS

Taxes; income tax; capital gains and losses; sale of patents; related persons; control; sham corporation.—Taxpayers seek refund of federal income taxes for years 1961–1963, together with interest, claiming that the royalty payments received by them under a patent sales agreement qualify for capital gains treatment under 26 U.S.C. § 1235. Mr. Charlson was the inventor and owner of patents relating to a high-torque, low-speed hydraulic motor and related devices, and for various business reasons entered into a patent sales agreement with a corporation (Germane) specially formed by four of his business associates and personal friends to exploit the patents. Mr. Charlson was never a shareholder in Germane, all the stock being owned by the four individuals. Plaintiffs contend that Mr. Charlson exercised no control over Germane which was independent and conducted its own business to advance its own interests without outside intervention or interference. Defendant contends that Germane is a sham corporation and/or controlled by Mr. Charlson. Upon review of the circumstances surrounding the transfer, the terms of the sales agreement, the rights transferred, the conduct of the corporation itself, and the extent of Mr. Charlson's dealings with Germane, it is *held* that the sales agreement transferred all of Charlson's substantial rights to his patents to Germane, that Germane was not related to or controlled by Charlson, that Germane was not a sham corporation, and that plaintiffs are entitled to long-term capital gains treatment for the royalty payments received from Germane pursuant to the agreement. Plaintiffs are entitled to recover $154,499.04, along with interest as provided by law from date of payment.

Taxes; income tax; capital gains and losses; sale or exchange of patents.

[1] Under 26 U.S.C. § 1235(d) a patent holder who transfers, directly or indirectly, his patent to a corporation in which the holder owns more than 25% in value of the outstanding stock, is not entitled to capital gains treatment for payments in consideration of such transfer, since such corporation is a "related person" within the meaning of the statute.

Internal Revenue ⟸ 409.6

Taxes; income tax; capital gains and losses; sale or exchange of patients.

[2] A patent holder who transfers all substantial rights in a patent to a controlled corporation is not barred from capital gains treat-

Syllabus

ment for payments in consideration of such transfer unless the corporation was also a "related person" within the purview of 26 U.S.C. § 1235(d). However, retention of control over an unrelated corporation can defeat capital gains treatment if the retention prevents transfer of "all substantial rights," because the holder's control over the unrelated transferee places him in essentially the same position as if all substantial rights had not been transferred.

Internal Revenue ⇐ 409.6

Taxes; income tax; capital gains and losses; sale or exchange of patents.

[3] 26 U.S.C. § 1235(d) was not intended to be an exclusive or exhaustive statement of the impact of control over a Sec. 1235(a) transferee by a patent transferor of all substantial rights in a patent, even though the concept of related person is essentially based on control.

Internal Revenue ⇐ 409.6

Taxes; income tax; capital gains and losses; sale or exchange of patents.

[4] Where C, under a patent sales agreement entered into at arm's length, assigned his right, title and interest in his patents to a small corporation G specifically formed to purchase and exploit the patents and comprised of four of C's business associates and close friends each of whom owned 300 shares of the 1,200 shares issued during G's existence, C was to receive 80% of the licensing royalties as well as a nonexclusive license to make and use the patented devices in the United States and to sell them abroad, and C retained the right to supervise quality control procedures, to cancel the contract upon G's default in royalty payments and to bring infringement suits in conjunction with G, but with no right to control or direct the litigation, such terms do not evidence C's control and domination of G sufficient to bar capital gains treatment for payments in consideration of the transfer within the purview of 26 U.S.C. § 1235.

Internal Revenue ⇐ 409.6

Taxes; income tax; capital gains and losses; sale or exchange of patents.

[5] The right of a patent transferor to terminate a patent sales agreement for nonpayment of royalties or his right to bring infringement suits in conjunction with the patent purchaser absent the additional right to control and direct the suits is not a substantial retained right disqualifying the transferor from capital gains treatment for payments in consideration of the transfer within the meaning of 26 U.S.C. § 1235.

Internal Revenue ⇐ 409.6

Taxes; income tax; capital gains and losses; sale or exchange of patents.

[6] Although the relations between the shareholders of specially-

Per Curiam

formed corporation G to which patent holder C transferred his right, title and interest in his patents and in which C held no stock, were cordial and founded on long-established friendships, as well as upon mutually beneficial business interests, and their dealings may have deviated appreciably from the standard business model of self-interest, coercive bargaining and partisan frictions and were such as to make the patent sales agreement between them highly conducive to the exercise of impermissible control by C, where the trial record demonstrates that such control did not in fact exist, where defendant has failed to present facts substantiating its allegation of control, where G exercised all substantial rights in the patents according to its own discretion although it sought, received and followed recommendations of C, the transfer was not a sale of patents within essentially the same economic group but was a transfer of all of C's substantial rights and qualified the payments received by C from G for capital gains treatment under 26 U.S.C. § 1235.

Internal Revenue ⇐ 409.6

Taxes; income tax; capital gains and losses; sale or exchange of patents; sham corporation.

[7] Even assuming that corporation G formed to exploit an invention covered by United States patent was a sham, where patent holder C and transferor to G of all substantial rights in the patent was not a member of the noncorporate group, had no economic interest in it, and G was not related or controlled by C, royalty payments in consideration of the transfer received by C from G qualify for capital gains treatment under 26 U.S.C. § 1235. A creditor interest is fundamentally different from a profit or equity interest.

Internal Revenue ⇐ 409.6

Bert B. Rand, attorney of record, for plaintiffs; *Hans A. Nathan*, of counsel.

Robert N. Dorosin, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant; *Robert H. McKnight, Jr.*, of counsel.

Before SKELTON, KASHIWA, and KUNZIG, *Judges*.

PER CURIAM: This case comes before the court on plaintiffs' motion filed July 16, 1975, requesting that the court adopt the recommended decision of Trial Judge Joseph V. Colaianni, filed June 3, 1975, pursuant to Rule 134(h), as the basis for its judgment in this case since defendant has failed to file a notice of intention to except thereto and the

time for so filing pursuant to the rules of the court has expired. Upon consideration thereof, without oral argument, since the court agrees with the recommended decision, as hereinafter set forth, it hereby affirms and adopts the same as the basis for its judgment in this case. Therefore, it is concluded that plaintiffs are entitled to recover $32,012.56 for 1961; $56,211.67 for 1962; and $66,274.81 for 1963, along with interest for each of the years as provided by law from the date of payment, and judgment is entered for plaintiffs accordingly.

OPINION OF TRIAL JUDGE

COLAIANNI, *Trial Judge:* This is a tax refund suit that arises as a result of Mr. Charlson's disposition of patents [1] to a corporation which was formed for the specific purpose of exploiting them. The question is whether the amounts received by plaintiffs in 1961, 1962 and 1963 from the Germane Corporation were taxable as long-term capital gains as reported on plaintiffs' joint federal tax return, or as ordinary income as defendant contends. The parties have stipulated that if plaintiffs prevail they are entitled to recover $32,012.56 for 1961, $56,211.67 for 1962, and $66,274.81 for 1963, along with interest as provided by law from the date of payment. For reasons hereinafter set forth, it is concluded that plaintiffs are entitled to judgment against the defendant for a refund of taxes in the amounts stipulated.

Background Facts

The facts are fully detailed in the findings of fact which accompany this opinion and will be repeated only to the extent necessary to an understanding of the result reached.

In about 1942, plaintiffs, as partners, purchased the assets of a bankrupt Minneapolis, Minnesota, machine shop. In early 1946, plaintiffs incorporated their business as the Char-Lynn Company. Plaintiffs and their daughter, Mrs. Donna Herzog, were for all relevant times the only shareholders of the corporation. Mr. Charlson is a self-educated engineer and businessman who served as president and the

[1] Although Mr. Charlson disposed of a number of patents and applications in the same transaction, United States Letters Patent No. 2,821,171, entitled "Fluid Pressure Device and Valve," is by and far the most important one.

guiding light of Char-Lynn. During the early years, plaintiffs' business was primarily a machine shop specializing in die-casting. While operating as a machine shop, the business grew from annual sales of approximately $500,000 in 1950 to $2,900,000 by 1958. Char-Lynn employed 120 persons in 1958.

Notwithstanding its growth, Mr. Charlson recognized the need for Char-Lynn to develop a unique product line if it was to be successful. Accordingly, Char-Lynn purchased a patented pneumatic tire spreader which it redesigned and marketed until 1949. In the early 1950's it manufactured and marketed a power pack. In 1954 or 1955 Mr. Charlson conceived, and later patented, a hydraulic valve device. Production of the device did not begin until about 1957.

As a result of his continuing search for a unique product line, Mr. Charlson became aware of the market potential for a high-torque, low-speed hydraulic motor. Mr. Charlson sought the assistance of various hydraulic experts to design and develop such a motor, but was told that such a motor did not exist and could not be built. Charlson decided to pursue the design on his own and, after considerable reflection, in late 1955, conceived his idea for a high-torque, low-speed motor. As conceived, the motor's key components consisted of a rotatable gerotor and a commutator valve mechanism for orbiting of the gerotor. He discussed his conception with a Mr. Harold Darr, the owner of an independent engineering consulting firm, who had assisted Mr. Charlson in the past on other projects. After considerable analysis and study, Mr. Darr concluded that the conception was sound and proceeded to build a model. Following some modifications and refinements in the design, the orbit motor was successfully reduced to practice.

A patent application on the invention was prepared and filed in the Patent Office on June 8, 1956. United States Letters Patent No. 2,821,171 issued in the name of Lynn L. Charlson on January 28, 1958.

Upon learning in October of 1957 of the eventual allowance of a patent on his orbit motor invention, Mr. Charlson gave serious thought to evaluating the commercial application and potential of the orbit motor. After discussions with

Mr. Darr, who personally made inquiries regarding exploitation of the motor patent with companies active in the fluid power field, Mr. Charlson decided to sell his orbit motor patent when it issued. Mr. Charlson's decision to sell his patent was based on a variety of considerations, including: a desire to keep the patent, insofar as his estate was concerned, and independent business asset isolated from any possible business reversal which Char-Lynn might suffer; a concern that Char-Lynn's limited capabilities could not adequately exploit the patent; a desire not to increase his already heavy workload at Char-Lynn; and his fear of having to include the patent in any future sale he might make of Char-Lynn.

Having decided to sell his patent, Mr. Charlson next considered the various sale options open to him. He was obviously interested in obtaining the best and highest price from a purchaser who would be monetarily motivated to exploit the full potential of the patent. Mr. Charlson was aware that the newly patented motor did not have proven applications or marketability, and was quite revolutionary in design. Thus, he did not feel that a large manufacturing company or a professional patent licensing company would offer him a fair price. He also feared that a large company might agree to purchase the patent and then not properly exploit it. The record does not indicate that he ever considered or approached any medium-size companies.

Mr. Charlson decided to sell to a group of his business associates and personal friends, and in early 1958 approached Ward B. Lewis, Esq., Char-Lynn's corporate counsel, his own personal attorney, and his long-time friend, to determine if he and three other individuals would be willing to form a new corporation to purchase his patents. The three others consisted of Mr. Harold Darr, who in 1959 was still a consulting engineer but would, after suffering a heart attack, become a full-time employee of Char-Lynn in 1964; Mrs. Beverly Scott, who was at the time a highly valued and trusted administrative assistant to Mr. Charlson at Char-Lynn; and Mr. Raymond O. Jensen, who had been a friend of Mr. Charlson and an employee of Char-Lynn for many years and was then serving as its comptroller.

The above individuals, in addition to being trusted, long-time business associates of Mr. Charlson who had each, in his own way, contributed to the growth of Char-Lynn, were suggested by Mr. Charlson because each possessed diverse business talents. Specifically, Mr. Lewis had proven legal experience; Mr. Darr had engineering and design capabilities; Mrs. Scott had administrative and coordinating experience; and Mr. Jensen had a good business background. At the time he approached them, Mr. Lewis explained that there would be no restrictions or limitations of any kind on the new corporation's ownership of the Charlson patents.

The four, partly because of their friendship with Mr. Charlson and partly because they thought it could prove to be monetarily rewarding, agreed to form the Germane Corporation to purchase the Charlson patents.

Each of the four shareholders paid for their own 300 shares of stock at the stated price of $1.00 per share. Mr. Charlson did not lend nor give any of the incorporators money to cover the purchase of their 300 shares of Germane stock. No other Germane stock beyond the initial 1,200 shares was issued during its entire existence. These individuals, except in the case of Mr. Lewis, who shortly after issuance of the stock transferred it to Mrs. Lewis, were the only shareholders of Germane during its entire existence.

Germane's certificate of incorporation issued on September 2, 1958. At the time of incorporation, Mr. Raymond O. Jensen was Germane's president; Mrs. Beverly Scott was vice-president and secretary; Ward B. Lewis, Esq., was vice-president and assistant secretary; and Harold N. Darr was treasurer. The above individuals constituted the only directors and office-holders of the corporation throughout its entire existence, except for Mr. Darr, who died in 1967. Upon the death of Mr. Darr, Mr. Jensen took over the position of treasurer while remaining as Germane's president. Neither Mr. Charlson nor any member of his immediate family was ever an officer or director of Germane. Mr. Charlson never attended any of the meetings of Germane's board of directors. Moreover, he was not an incorporator of Germane and never owned any shares of that company. The record does

not show and defendant does not contend that Mr. Charlson made any loans to the officers or directors of Germane.

After the formation of Germane, Mr. Lewis, as Germane's representative, and Merchant & Merchant, an independent patent law firm as Mr. Charlson's representative, drew up a patent sales agreement to transfer all of Mr. Charlson's rights, title and interest to his various patents and patent applications to Germane. Mr. Charlson did, however, retain his right to:

> (1) inspect samples of orbit motors made by any of Germane's licensees and make recommendations for quality control purposes;
> (2) cancel the contract upon Germane's failure to make the agreed to payments; and
> (3) bring patent infringement suits in conjunction with Germane, but without the right to control the action.

In exchange, and as consideration for the transfer of all rights, title and interest to the various Charlson patents and applications, Germane promised to pay Mr. Charlson 80 percent of all royalties it received from the licensing of the various patents. Germane was to receive 20 percent of the royalties. The 80/20 percent arrangement was substantially similar to other arm's-length patent sale agreements.[2]

Concurrent with the execution of the sales agreement, Germane granted Char-Lynn a nonexclusive license to make and use devices covered by the patents and patent applications in the United States and to sell them throughout the world. Char-Lynn manufactured approximately 100 motors in 1958. It increased its production in 1959 to about 1,000 motors. Some 1,500 motors were produced by Char-Lynn in 1960. Production doubled over the succeeding years so that

[2] In *Van Dale Corp.*, 59 T.C. 390, 396 (1972), the patent sale agreement provided for the owner to receive 90 percent of the royalties earned by the patents while the purchasing company was to retain 10 percent. The court, commenting on this agreement, states:

"We note first that respondent has not contended that the consideration paid by NSP to acquire the patents was less than what would have been paid by a corporation with no ties at all to petitioner. In fact, the terms existing between petitioner and NSP [NSP to receive 90 percent of the royalties earned and plaintiff to retain 10 percent] were basically identical to those offered by University [another patent holding company] to acquire petitioner's patents."

by 1965 Char-Lynn produced about 80,000 units. The number increased to 120,000 for 1966 and approximately 200,000 by 1970. As a result of this growth, the orbit motor had, by 1965, become Char-Lynn's most important product. In terms of dollars, the sales of the hydraulic motors increased from $177,796 in 1960 to $7,409,529 in 1968. Moreover, by 1970 Char-Lynn's total tales amounted to approximately $19,900,000 and it employed some 600 persons.

Germane also granted other licenses. In 1961, Danfoss A/S, a Danish corporation, was granted an exclusive license to make, use and sell devices covered by the patents in Europe. The granting of an exclusive license to Danfoss required Char-Lynn to give up its right to sell its motors throughout the world. The record clearly demonstrates that Char-Lynn had not by 1961 established a worldwide program to sell its orbit motors and it was thus willing to give up its unexercised rights. Danfoss' need for technical assistance in setting up its production facilities for the orbit motor, and, as well, its need for an immediate supply of motors until it had the opportunity to tool up and establish its own production lines, required the assistance of both Mr. Charlson and Char-Lynn during the negotiations of the Danfoss A/S license. Germane was represented by Mr. Lewis during the negotiations.

Germane also granted an exclusive license in 1961 to Moore Hydraulics Pty., Ltd., of Australia, hereinafter referred to as "Moore." The license granted Moore the exclusive right to make, use and sell orbit motors in Australia and New Zealand. It appears that sales of the motors in that area did not materialize to the point where Moore could justify the tooling up costs required to produce the motors in Australia, and thus Moore has been satisfied to purchase motors from Char-Lynn for resale in its licensed area. During the license negotiations with Moore, Mr. Jensen represented Germane. Mr. Charlson and Char-Lynn attended the negotiations.

In the early 1960's, Ross Gear Company had expressed an interest in obtaining a license under the Germane patents. However, as a result of Ross' refusal to pay Germane a standard 5 percent royalty, the license negotiations failed. Ross, nonetheless, went on to manufacture a steering device

for off-the-highway equipment, which Char-Lynn's sales engineers felt infringed the orbit motor patent. As a result, a patent infringement suit was jointly brought by Germane, Char-Lynn, and Mr. Charlson against Ross Gear and its successor in interest, TRW, Inc. The infringement suit was settled by a cross-licensing agreement executed on August 2, 1966, which, in accordance with the terms of the agreement, granted TRW, Inc., a nonexclusive license to manufacture and sell orbit motors for use in a power steering system of specific design.

The only other Germane licensee was Lamina, Inc., hereinafter referred to as "Lamina," a Michigan corporation whose principal business in the early 1960's was the manufacture of lamination dies for the electrical motor industry and the manufacture of bronze bushings and wear plates for the machine tool industry and the general die industry. Lamina became interested in the orbit motor as a result of its work toward the development of a transportable, powerful drilling apparatus for use in restricted areas. The orbit motor was ideally suited for such an assignment because it did not need a separate speed reduction unit, such as was required by electric motors. As a result, on April 3, 1964, Lamina was granted an exclusive license to manufacture the patented orbit motor provided that the main motor shaft was equipped with a permanently-affixed device (such as a chuck or collet) adapted to hold tools for rotary machining operations.

By subsequent negotiations, the parties ultimately agreed to a broader 1967 agreement in which Germane granted Lamina a nonexclusive license to sell the orbit motor to the machine tool industry.

A review of the licensees indicates that Char-Lynn's operations were the broadest in scope. This is evident from the fact that two of the licensees were exclusively foreign based. Particularly, Danfoss operated solely in Europe, while Moore Hydraulics bought motors from Char-Lynn for resale in Australia and New Zealand. The Ross Gear Division of TRW was authorized to use the orbit motor in connection with a power steering system of a specific design. Only Lamina, with its license to sell the motor to the machine

tool industry, provided potential competition to the orbit motors made and sold by Char-Lynn.

In late 1968, Mr. Charlson, for reasons of health, decided to sell Char-Lynn. He did not inform any of the Germane stockholders of his decision, but Mrs. Scott, as a result of her employment at Char-Lynn, learned of this decision in August of 1970. In the meantime, by late 1969, the shareholders of Germane had independently, and without knowledge of Mr. Charlson's intentions, decided to sell either the Germane stock or its assets, *i.e.*, its patents. Germane's decision was based on a variety of considerations, including:

1. The shareholders had aged and wanted to divorce themselves of these additional responsibilities;
2. Mr. Darr had died and that left only three directors, none of whom was technically competent, to make all of Germane's decisions; and
3. The patents had proved to be of great value and their successful exploitation was beyond Germane's fairly amateur capabilities.

Germane did not inform Mr. Charlson nor any of its licensees of its decision to sell. Instead, it hired an independent patent attorney, Dan Stice, Esq., who was active in the licensing of patents, to arrange a sale. As a result of Mr. Stice's efforts, on June 30, 1970, Messrs. Lewis and Stice visited the Eaton Corporation in Cleveland, Ohio. They met with two Eaton patent attorneys, who informed them of Eaton's interest in the Germane patents.

During this period of time, Mr. Charlson was engaged in serious negotiations for the sale of Char-Lynn stock with several companies, including the Sperry Rand Company. A sale of Char-Lynn to Sperry Rand was imminent when Eaton, who was then negotiating with Germane, approached Mr. Charlson about buying Char-Lynn. Eaton notified plaintiff and his counsel, Bert B. Rand, Esq., that it had already been approached by Germane, and that it was interested in purchasing the Germane patents.

As a result of the discussions, Eaton made an offer to buy Char-Lynn which was better than Sperry Rand's offer. In addition, Eaton agreed to pay Mr. Charlson 8 million dollars ($8,000,000) for all of his right, title and interest in the balance of the purchase price due him from Germane under

the patent sales agreement. Eaton could have refused to close with Germane if its negotiations with Mr. Charlson involving the sale of his residuary rights were unsuccessful. On December 28, 1970, the sales between Eaton Corporation and Germane and between Eaton Corporation and Mr. Charlson were consummated. Each party to these transactions was represented by independent counsel of its own choice.

For at least the years in question, 1961 through 1963, inclusive, plaintiffs computed their federal income tax and filed their returns on the premise that the payments they received from Germane in consideration for the transfer of the Charlson patents and applications were taxable as capital gains. On audit, the Internal Revenue Service determined that the payments were not entitled to capital gains treatment and assessed deficiencies accordingly. Plaintiffs paid the assessments and upon formal disallowance of their timely-filed claims for refund, brought this action.

Issues

Defendant argues that the royalty payments from Germane to Mr. Charlson under their patent sales agreement are ordinary income rather than capital gains, because, for the purposes of 26 U.S.C. § 1235, Germane is a sham corporation and/or controlled by Mr. Charlson. Plaintiffs, on the other hand, contend that the royalties they received are entitled to capital gains treatment under 26 U.S.C. § 1235 since Mr. Charlson exercised no control over Germane and since Germane was an independent corporation which conducted its own business to advance its own interests without outside intervention or interference. Each of defendant's contentions will now be considered.

Germane was not Controlled by Mr. Charlson

Section 1235, which deals with the sale or exchange of patents, provides in pertinent part:

> (a) *General.*—A transfer (other than by gifts, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capi-

tal asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(1) payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) contingent on the productivity, use, or disposition of the property transferred.

* * * * *

(d) *Related persons.*—Subsection (a) shall not apply to any transfer, directly or indirectly, between persons specified within any one of the paragraphs of section 267(b); except that, in applying section 267 (b) and (c) for purposes of this section—

(1) the phrase "25 percent or more" shall be substituted for the phrase "more than 50 percent" each place it appears in section 267(b), and

* * * * *

Thus, 26 U.S.C. § 1235 does not speak in terms of sham or controlled corporations. Instead, § 1235(a) confers capital gains treatment on a "transfer * * * of property consisting of all substantial rights to a patent * * * by any holder * * *." However, § 1235(d) denies such treatment to transfers, "directly or indirectly,"[3] between certain related persons. In particular, a corporation in which the holder owns more than 25 percent in value of the outstanding stock, directly or indirectly (with 26 U.S.C. § 267(c) attribution rules applying), is a related person under § 1235(d).

It is clear from the facts and not disputed by defendant that Germane is not related to Charlson within the *literal* meaning of § 1235(d). Nor has defendant suggested that any of the rules or guidelines which define "related persons" be interpreted to cover the situation at bar. Indeed, any such interpretation would be directly contrary to the manner in which the statute has been previously applied. In *Lee* v.

[3] This phrase was made a part of 26 U.S.C. § 1235(d) as a result of an amendment effective September 3, 1958. The patent sales agreement, although executed about September 25, 1958, was effective January 28, 1958, when an oral agreement between the parties was reached. This intervening amendment does not affect the analysis of plaintiff's liability, since, for reasons stated in *Myron C. Poole*, 46 T.C. 392 (1966), the amendment is simply declaratory of prior law.

United States, 302 F. Supp. 945 (E.D. Wis. 1969), the holder owned 24 percent of the stock of the transferee corporation but was still found to be entitled to capital gains treatment. *See also B. J. Semel*, 33 CCH Tax Ct. Mem. 248 (1974), a case involving 26 U.S.C. § 1239, in which the court applied the 80 percent rule literally. Thus, even assuming that Germane was a controlled corporation, it would still be necessary to demonstrate that the § 1235(d) requirements existed in order to conclude that Germane was "related" to Mr. Charlson.

Nevertheless, it is equally clear that retention of control by a holder over an unrelated corporation can defeat capital gains treatment, if the retention prevents the transfer of "all substantial rights." This is because the holder's control over the unrelated transferee (within the meaning of § 1235) places him in essentially the same position as if all substantial rights had not been transferred. The purpose and policy of § 1235(a), as expressed in the legislative history, provides support for such an interpretation. Specifically, with the obvious intent of having a transferor's acts speak louder than his words in establishing whether a sale of a patent has occurred, the Senate Finance Committee stated:

> * * * [i]t is the intention of your committee to continue this realistic test * * * developed under prior case law * * *, whereby the entire transaction, regardless of its formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee, rather than recognizing the less relevant verbal touchstones * * * in the transfer agreement * * *.[4]

See also Oak Mfg. Co. v. *United States*, 301 F. 2d 259 (7th Cir. 1962), where the court concluded that retention of control over substantial rights by the transferor rendered the "sale" an agency agreement, which contemplated a continuing relation rather than a bona fide sale and release of rights. It should be stressed that § 1235(d) was not intended to be

[4] S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 439–40 (1954).

an exclusive or exhaustive statement of the impact of control over a § 1235(a) transaction, even though the concept of related person is essentially based on control.[5]

Both sides rely on *Puschelberg* v. *United States*, 330 F. 2d 56 (6th Cir. 1964). In that case, Puschelberg and a joint inventor were awarded a patent for a disposable blood filter. They, in turn, granted Baxter Laboratories, Inc., an independent ethical pharmaceutical house in the drug industry, an exclusive license under the patent. Baxter at the same time gave Puschelberg's company ("Fabricated") a nonexclusive license to manufacture the filters which Baxter would buy from it at a set price. The sales agreement also provided that if Baxter licensed anyone else, a percentage royalty based on sales would be paid to the co-inventors. The Government in that case argued that Puschelberg and his co-patentee did not transfer "all substantial rights to * * * [the] patent" to Baxter as is required by 26 U.S.C. § 1235(a), but that Puschelberg and the co-patentee retained substantial manufacturing rights. The facts in *Puschelberg* indicate that Baxter only granted one license, and that was to Puschelberg's corporation, Fabricated. However, Baxter did have the right to grant as many licenses as it desired. The Sixth Circuit was unpersuaded that any tacit agreement or retained control existed and held that the co-patentees had disposed of all their rights under the patent.[6] Specifically, the court stated, at p. 61:

> We do not so construe the agreement. Baxter clearly acquired the right to manufacture the filters under the

[5] *Id.*, pp. 440–41, and H.R. Rep. No. 1337, 83d Cong., 2d Sess., p. A280 (1954):

"* * * The sale of a patent between an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual would not * * * be entitled to capital gain treatment under this section. It is not considered that this limitation will in any way narrow the opportunity of inventors to dispose of their patents through normal business channels; on the other hand, this limitation should prevent possible abuses arising from the sale of patents within *essentially the same economic group.*" [Emphasis added.]

[6] Indeed, the court agreed with the District Court's conclusion that all substantial rights under the patent, as defined by *Waterman* v. *MacKenzie*, 138 U.S. 252 (1891), were transferred and that, accordingly, an assignment of the patent had taken place.

agreement. The agreement also gave Baxter the right to have the filters manufactured for it. This did not confer upon the taxpayer any right to manufacture the filters, but merely authorized Fabricated to manufacture the filters if Baxter asked it to do so. The District Judge found that it was the understanding of both of the contracting parties that in executing the license agreement, the co-inventors were disposing of all their rights to the invention.

Puschelberg involves a legal question which is quite similar to that which defendant presents in this case. However, the case at bar is factually distinguishable from *Puschelberg*. Baxter Laboratories was a large, independent, well-established Delaware corporation. There was no showing that the co-inventors and Baxter had ever had any prior dealings. The assignment to Baxter and the nonexclusive license back to Fabricated were arm's-length transactions. Moreover, the fact that Baxter did not have a need for more filters than Fabricated could produce provided a business justification for Baxter's issuing only one license. These facts are contrasted with the facts in the case at bar where close personal friendships and business association between Mr. Charlson and Darr, Scott, Jensen, and Lewis existed for many years prior to the formation of Germane. And, although neither Darr, Scott, Jensen, nor Lewis was related in any sense to Charlson, each had either worked for Mr. Charlson or Char-Lynn at some time. These circumstances make more probable, whether pursuant to some mutual understanding or not, the existence of retained control.

However, this probability falls far short of proof. Indeed, the record shows that in late 1957 the main Charlson patent was just about to issue and plaintiff felt that he was at a disadvantage in trying to negotiate a sale of an unproven product at the highest price with the larger companies. Mr. Charlson, for the very same reason, feared that the larger companies would not proceed with the full exploitation of the patent. On the other hand, Mr. Charlson felt that Germane would be fair to him.

The explanation for his decision against either selling the patents to Char-Lynn [7] or having Char-Lynn manufacture the motor under a license from him appears in the trial record. Particularly, the record clearly establishes Mr. Charlson's desire to reduce his workload at Char-Lynn. Mr. Charlson also explained his suggestion of Darr, Scott, Jensen, and Lewis as shareholders in Germane by the fact that they all possessed skills valuable to a small, new patent licensing corporation. However, it is also apparent that the choice of shareholders was greatly influenced by Mr. Charlson's friendship with these people and his thought, no doubt present, that they would be less likely to do things adverse to his interests than a large unknown company would.

The trial record as a whole did not show that Mr. Charlson controlled the operation of Germane. While he or a Char-Lynn representative was present at various stages of some of the negotiations between Germane and the other licensees, this presence is explainable on the basis of either Char-Lynn's interest as a manufacturer and licensee or of Charlson's own monetary interest in seeing that the best licensees were selected. Char-Lynn's interest resulted from its sale of motors to Danfoss, Moore Hydraulics, and even Lamina for varying times until each could develop its own manufacturing facilities. In addition, Char-Lynn and Mr. Charlson were joint plaintiffs, along with Germane, in the Ross Gear infringement suit. Char-Lynn obviously did not want the scope of its license adversely affected by the sale of motors by the others contrary to the terms of their licenses. Charlson's participation in the licensing negotiations was advantageous to Germane because as the inventor he could explain the technical difficulties and advantages of the motor to the prospective licensees, and otherwise generally be of aid to Germane in obtaining good licensing terms. It obviously was to Germane's and Mr. Charlson's mutual advantage to obtain as high a royalty as possible because of their respective rights

[7] Char-Lynn at the time of sale in 1958 was partially owned by Charlson's daughter. It was Charlson's impression then that with a timely gift of stock to his daughter, Char-Lynn would become unrelated to him for purposes of capital gains treatment on a sale. Whether or not this impression is actually correct does not matter. Charlson's belief in it shows that he thought he had a viable choice to make and lends credibility to his given reasons for a sale to Germane.

to 20 percent and 80 percent of the royalties collected from the licensees.

The record clearly shows that Charlson, Char-Lynn, and Germane operated quite effectively as a group and were solicitous of each other's individual interests as well as their mutual interests, of which the financial success of the motor was by far the most important.

Finally, the patent sales agreement itself does not contain any terms which can be pointed to as evidence of Mr. Charlson's control or domination of Germane. Charlson never exercised his retained right to supervise quality control procedures in such a way as to eviscerate Germane's rights, as owner of the patent. Nor has defendant pointed to anything which shows that Mr. Charlson and not Germane decided the terms of the various license agreements. Indeed, the record does not establish that Mr. Charlson exercised what have come to be recognized as proprietary acts over the transferred patents. *William W. Taylor*, 29 CCH Tax Ct. Mem. 1488 (1970). The right of Charlson to terminate the license for nonpayment of the royalties is not a substantial retained right, *Bell Intercontinental Corp.* v. *United States*, 180 Ct. Cl. 1071, 381 F. 2d 1004 (1967); *Arthur M. Young*, 29 T.C. 850 (1958), and does not suggest on the facts of record a retention of control through use of a threat to terminate. The inventor-transferor's right to bring infringement suits in conjunction with the patent purchaser is likewise not a substantial right in the absence of the additional right to control and direct the suit. This control is especially critical where the transferor's compensation for his patent is calculated on a royalty-use percentage basis. *Oak Mfg. Co.* v. *United States*, *supra*. In this case, Mr. Charlson did not have the right to control or direct infringement suits. Certainly, defendant has not pointed to any action by Mr. Charlson in connection with the Ross Gear infringement suit, which was brought by Germane, Mr. Charlson and Char-Lynn, that would support any charges of control over that suit by plaintiff.

In summary, although the many and varied business and personal relations between the shareholders of Germane and Mr. Charlson were such that they would make any patent

sales arrangement between them highly conducive to the exercise of impermissible control by the transferor over the transferee, the proof of record fails to support defendant's charges. While such control was easily possible, the plaintiff has adequately demonstrated that it did not in fact exist. The defendant has failed to present facts to substantiate its allegation of control. By the patent sale agreement, Charlson transferred all substantial rights in his various patents and applications to Germane. Germane exercised these rights according to its own discretion, although it frequently sought, received, and followed the recommendations of Charlson.

Defendant's argument that Germane's license program is also evidence of Mr. Charlson's control and domination of Germane will next be considered. As previously mentioned, the licensees, Danfoss and Moore, were exclusively foreign based and thus provided no competition to Char-Lynn's operations in the United States. The license to the Ross Gear Division of TRW, for a particularly designed power steering system, similarly did not offer much competition to Char-Lynn. Only the license to Lamina, which authorized the sale of orbit motors to the machine tool industry, could in theory compete with Char-Lynn. It should first be recognized that Char-Lynn did indirectly benefit from some of the above licenses since it was called upon to supply orbit motors for the licensees until they were able to set up their own production facilities. However, this small indirect benefit hardly establishes defendant's charge.

To the contrary, it was explained that a desired licensee, one with adequate financial backing and of medium size, never appeared and requested a license. Moreover, the trial record establishes, without contradiction by defendant, that a deficiency of a key component, the gerotor, of the orbit motor seriously limited the total number of motors which could be produced. Particularly, the record establishes that each of the licensees, with the possible exception of Danfoss, purchased gerotors from the Nichols Company. Although various efforts were made to both develop a second source and to have the Nichols Company expand its production (which was eventually done), a serious shortage of gerotors remained

throughout Germane's existence. The thrust of the uncontradicted testimony at trial established, because of the shortage of gerotors, that the granting of additional licenses would only result in a large number of licensees making the same number of orbit motors. Thus, there would not be an increase in the amount of royalties that Germane could collect and under these circumstances there was no incentive for it to actively seek licensees.

A review of *Myron C. Poole*, 46 T.C. 392 (1966), indicates that factors which are not present in the case at bar convinced the Tax Court of plaintiff-Poole's nonentitlement to capital gains treatment for monies received from Revolvex. In *Poole*, the inventor of the rotating mobile home window "sold" his patent to the Revolvex Corporation, a company which conducted substantial business activities in the sense of *Moline Properties* v. *Commissioner*, 319 U.S. 436 (1943), but which Poole completely dominated and controlled. The facts in that case show that Poole was president of Revolvex and owned 50 percent of the stock outright with a substantial portion of the remainder being constructively held for him. Poole also owned 80 percent of the outstanding stock of Ventoura Corporation. Ventoura actually manufactured mobile homes with rotating windows. Revolvex, which purportedly purchased the patent, licensed Ventoura on a nonexclusive basis. Thus, at times Poole signed both parts of two-party agreements between Ventoura, Revolvex and Poole; one part as president of Revolvex, and the other part as Poole, the inventor, or as Poole, the president of Ventoura Corporation. The Tax Court found that:

> The terms of these contracts were such that Revolvex could never earn any significant income; it was merely a conduit to pass the royalties through to Poole. [46 T.C. at 404.]

In addition, Poole admitted to having Revolvex cancel the license of its only other licensee when he felt it was in the best interests of Ventoura to have an exclusive license. Thus, the court concluded that "* * * Poole used his control of Revolvex in such a way as to enhance the profits of Ventoura—but not so as to make profits for Revolvex." Accordingly, using the "doctrine of step transactions," whereby—

> * * * the tax consequences of a series of transactions are ascertained, not from the form of each transaction, but from a comparison of the economic realities at the beginning and at the conclusion of the series * * * [46 T.C. at 402]

the Tax Court held that:

> * * * the transfer of patents from Poole to Revolvex was not a transfer to an unrelated person, as contemplated by section 1235, because it was, in substance, an indirect transfer to Ventoura, a related person. The patents remained within essentially the same economic unit and subject to the holder's [Poole's] control. [46 T.C. at 403.]

In the instant case, Mr. Charlson had no interest, stock or otherwise, in Germane. Moreover, there has been no showing that Germane deliberately limited the number of licenses to benefit Mr. Charlson and/or Char-Lynn. Indeed, Germane's ownership over the patents is evidenced from its sale of the same to Eaton Corporation after apparently taking into consideration only what was most advantageous to Germane and its shareholders.

On balance, it is concluded that the 12-year business arrangements between Germane, Char-Lynn, and Mr. Charlson were cordial and founded on long-established friendships, as well as upon mutually beneficial business interests. The dealings between the parties may have deviated appreciably from the standard business model of self-interest, coercive bargaining, and partisan frictions which the Government impliedly urges as the appropriate standard for comparison. Nonetheless, the disposition of Charlson's patents and applications to Germane, since it did transfer all of his substantial rights under his patents and applications to Germane, was not a sale of patents within essentially the same economic group and does qualify under 26 U.S.C. § 1235 for capital gains treatment.

Germane was not a Sham Corporation

In addition to defendant's argument that Germane was controlled by plaintiff, defendant also urges that Germane was a sham corporation and I now turn my attention to con-

sider the merits of this latter contention. Defendant's sham corporation argument requires an approach which is fundamentally different from its "control" argument. Under the "control" argument, defendant in effect admitted the existence of Germane but insisted that it was controlled by Mr. Charlson and that no substantial rights of Charlson, within the meaning of 26 U.S.C. § 1235, were transferred to Germane under their patent sale agreement. On the other hand, under the sham corporation argument, defendant not only does not, for tax purposes, concede the existence of Germane, but, to the contrary, denies its very existence. *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945); *Higgins* v. *Smith*, 308 U.S. 473 (1940); *Gregory* v. *Helvering*, 293 U.S. 465 (1935).

Accordingly, defendant must now urge that all of Germane's activities, including the licenses it granted, were for all intents and purposes actually conducted and/or awarded by its individual shareholders operating as a noncorporate group. Fleshing out defendant's sham theory, it follows that royalties received by the noncorporate group would be taxed at a rate dictated by the various individual licenses. Specifically, receipts from a nonexclusive license would be treated as ordinary income, while royalties from an exclusive license, which could perhaps qualify as a sale, might be entitled to long-term capital gain treatment.[8] *See Estate of Klein*, 184 507 F. 2d 617 (7th Cir. 1974), *rev'g* 61 T.C. 332 (1973), *cert. denied*, 421 U.S. 991 (1975); *First Nat'l Bank of Princeton* v. United States, 136 F. Supp. 818 (D. N.J. 1955); *Vincent A. Marco*, 25 T.C. 544 (1955).

A threshold problem which defendant's sham theory encounters is its relevancy, for tax purposes, to Mr. Charlson. Indeed, the sham theory, if it is to have any vitality, must be grounded on the proposition that Mr. Charlson, as the inventor and holder of the patents, was a member of the noncorporate group which granted the licenses to Danfoss, Moore, Char-Lynn, the Ross Gear Division of TRW, and Lamina. The fallacy of defendant's theory becomes evident after a moment's reflection because even assuming that

[8] Provided, of course, that the noncorporate group could meet the conditions of 26 U.S.C. § 1221 or § 1235.

Germane is a sham corporation, Mr. Charlson is still entitled to § 1235 benefits so long as Germane is not a related or controlled sham corporation. In other words, under § 1235, Charlson can sell either to a sham or a bona fide corporation but he cannot sell to a controlled or related sham or to a controlled or related bona fide corporation. Thus, showing that Germane is a sham, without showing that Charlson is a member of the noncorporate group that remains after the corporate facade has been stripped away and without showing that the group runs afoul of the conditions of § 1235(d), will not suffice to deprive Charlson of the capital gains benefits afforded by that section.

In this case, it is clear that Charlson was not a member of the Germane group, even though it was stated heretofore that Germane, Char-Lynn and Mr. Charlson operated quite effectively together. It has previously been amply demonstrated that Charlson did not control Germane's activities or dictate its acts. It is, of course, recognized and acknowledged that by itself, lack of control does not establish lack of membership in the group under consideration. Indeed, Charlson could have been a member of the group without controlling it. However, the evidence of record fails to establish that Mr. Charlson was a member of a noncorporate group which owned and controlled his patents. To begin, defendant has not shown that he ever participated, or was given the opportunity to participate, in business meetings called by Germane to discuss its licensing procedures and policies. There certainly was no showing that Mr. Charlson participated in any day-to-day business meetings of Germane. Finally, aside from being Germane's largest creditor, Mr. Charlson had no economic interest in it. It is important to reemphasize at this point that a creditor interest is fundamentally different from a profit or equity interest.

Not only does the sham corporation theory fail because of defendant's failure to show that Mr. Charlson was a member of a noncorporate group which in reality conducted the business affairs of Germane, but it also fails for the more important reason that the trial record convincingly demonstrates that Germane was a viable entity that conducted business to advance its own interests. The trial record establishes

that Germane did conduct substantial business activities in the sense of *Moline Properties*, *supra*, by holding and exploiting the patents through a scheme of centralized management independent of the shareholders' personal resources and careers. *See*, *e.g.*, *Commissioner* v. *Laughton*, 113 F. 2d 103 (9th Cir. 1940). Moreover, Germane's shareholders and directors conducted its business with Germane's self-interest in mind rather than with simply their own separate, individual self-interests in mind. As a result, Germane made substantial earnings and passed them along to its shareholders. Its 20 percent share of the royalties grew from about $12,725.10 in 1958, when it paid $8,100 in salaries and $2,463 in dividends, to a peak of $219,825.64 in 1969, when it paid $10,050 in salaries and $86,524.25 in dividends.

It should also be emphasized that the Germane shareholders gained no particular tax advantages by operating as a corporate business entity. At this point, it is worthwhile to compare *Higgins* v. *Smith*, *supra*, which involved a sale by a sole shareholder to a corporation where the shareholder sought to treat the sale as a taxable transaction between two taxable entities for purposes of recognizing a loss deduction, with *Moline Properties* v. *Commissioner*, *supra*, where the taxpayer-shareholder wanted the corporate form disregarded in order to avoid double taxation on the sale of assets. In this instance, Germane was a personal holding company, and, as such, was subject to a personal holding company tax for any monies it retained. 26 U.S.C. § 541, *et seq.* (1970). To avoid this added tax, Germane distributed its income, within the meaning of the personal holding company tax provisions, to its shareholders who would report the dividend as ordinary income. The primary result is that Germane could not be used to accumulate royalty income, taxed at corporate rates, and to shield it from the higher tax rates for individuals. The absence of any definite tax advantage to operating as a corporation tends to reinforce the facts indicated that Germane was organized and operated for business purposes and that it was not a sham.

In sum, Germane was a viable corporation which owned its own assets, conducted its own licensing, earned its own money, and distributed it as it saw fit to advance its own

needs and interests. The facts of this case dictate that Germane was not a sham corporation.

It must, therefore, be concluded that the sales agreement between Mr. Charlson and Germane did in fact transfer all of Charlson's substantial rights to his patents and applications in accordance with the terms of 26 U.S.C. § 1235 and plaintiffs are entitled to long-term capital gains treatment for payments received from Germane pursuant to said sales agreement. Accordingly, plaintiffs are entitled to recover $32,012.56 for 1961; $56,211.67 for 1962; and $66,274.81 for 1963, along with interest for each of the years as provided by law from the date of payment.

FINDINGS OF FACT

1. Plaintiffs on March 25, 1971, filed their timely petition pursuant to 28 U.S.C. § 1491 for recovery of income taxes which plaintiffs alleged were illegally and erroneously assessed against and collected from them for each of the years 1961, 1962 and 1963.

2. Defendant on August 4, 1971, filed its answer, admitting the timeliness of the petition and all other facts on which the jurisdiction of this court is based.

3. During the years 1961, 1962 and 1963, and prior thereto, Lynn L. and Beryl W. Charlson were citizens of the United States, husband and wife, residing in the city of Minneapolis, Minnesota. Their federal income tax returns for each of the above years were filed with the District Director of Internal Revenue, St. Paul, Minnesota.

4. After working in several different jobs, Mr. Charlson, a self-educated engineer, entered into a partnership for the making of carbonators and drink dispensers. In 1941 the partnership employed Mr. Raymond O. Jensen as a bookkeeper. The partnership also used the legal services of Ward B. Lewis, Esq. Plaintiff in 1942 sold his interest in the partnership for $30,000.

5. In May of 1942 plaintiffs, as partners, purchased the assets of a bankrupt machine shop located in Minneapolis.

6. In early 1946 the machine shop was incorporated as Char-Lynn Company. The legal work to incorporate the shop was done by Ward B. Lewis, Esq., a Minneapolis attorney

engaged in private practice. Initially, Mr. Lewis received a monthly retainer of $300; however, this was later increased and around 1957 or 1958 he was receiving a retainer of between $300 and $1,000 per month. From the early years of incorporation of the Char-Lynn Company, Mr. Lewis was retained as corporate counsel and secretary of Char-Lynn. He also served on the corporation's board of directors.

7. Plaintiffs were the original stockholders of Char-Lynn.

8. While during the years 1951 through 1961 plaintiffs' daughter, Donna Herzog, owned a maximum of 13.52 percent of Char-Lynn's outstanding common stock, by 1962 plaintiffs, as a result of a gift program, had given her about 32 percent of the outstanding common shares. Mrs. Herzog's percentage ownership was maintained until at least 1969.

9. Char-Lynn initially operated as a contract machine shop and as such made parts for other companies. Following World War II, the company began to diversify into the manufacturing business. Although by late 1957 it had become a large machine shop or fabricator, the company remained a "small business."

10. While in 1950 the annual sales of Char-Lynn were approximately $500,000, they increased to $2,400,000 in 1957 and by 1958 they had grown to $2,900,000. Char-Lynn employed about 120 people in 1958.

11. In the interest of expanding and diversifying the company, Mr. Charlson from a very early time decided it would be necessary to develop its own product.

12. To this end, Mr. Charlson purchased a patent covering a pneumatic tire spreader and after some redesign manufactured and marketed a commercial product with immediate success.

13. The tire spreader was marketed by Char-Lynn until 1949.

14. In the early 1950's, Char-Lynn manufactured and marketed under the trademark "High-Low Pack" an unpatented power pack consisting of pump valves, a relief valve, and a reservoir. During 1954 or 1955, Mr. Charlson conceived a hydraulic valve device. This device was later patented. Production on the device did not begin until 1957.

15. Notwithstanding Char-Lynn's efforts, beginning in the late 1940's and extending until 1957, to diversify its product line, die-casting remained its dominant business.

16. Mr. Charlson's desire to find a product upon which to build Char-Lynn's business resulted in his awareness of the great market potential for a high-torque, low-speed hydraulic motor. As a result of his inquiries, Mr. Charlson foresaw a tremendous market for such a motor. He was convinced that a hydraulic motor having these characteristics was the most important product that a company could have, and the addition of such a motor to Char-Lynn's product line became his prime objective.

17. Outside consulting engineers and large hydraulic companies told Mr. Charlson that such a hydraulic motor did not exist and could not be built. As a result, he decided to explore the problem personally.

18. Because of some early 1952 work on a hydraulic pump which Char-Lynn conducted on behalf of a customer, Mr. Charlson became familiar with the use of a gerotor as a displacement mechanism for hydraulic pumps. Further investigation disclosed that the gerotor was invented and patented by a Professor Hill of the Massachusetts Institute of Technology and gerotors were manufactured under license from Professor Hill by the Nichols Company of Boston, Massachusetts.

19. Mr. Charlson visited the Nichols Company within 6 months of the expiration date of Professor Hill's patent in the hopes of buying gerotors. After unsuccessfully seeking a meeting with Professor Hill to obtain a license, the Nichols Company agreed to ship a few gerotors to Char-Lynn.

20. Following receipt of the gerotors at Char-Lynn, castings were designed as housings therefor. Upon holding the casting and rotating the gerotor, Mr. Charlson sensed that he had come upon a solution to his long-dreamed-of, high-torque, low-speed hydraulic motor.

21. Mr. Charlson was convinced that a hydraulic motor could be manufactured if a suitable commutator valve mechanism for orbiting the gerotor could be designed. He, therefore, took a gerotor home with him and put it on the side of his chair. Every evening thereafter for several years the last

thing he would do was pick the gerotor up and orbit and rotate it in an attempt to mentally picture a suitable valve mechanism. One evening in late 1955, he conceived a new mechanism and made sketches of the concept as best he could so he would not forget it.

22. Upon awaking the next morning, Mr. Charlson looked at the sketches he had made the evening before, recalled his mental picture and concluded that he had, subject to refinements, the design for a high-torque, low-speed hydraulic motor.

23. Mr. Charlson proceeded to meet with Mr. Harold Darr, the owner of an independent consulting firm and model shop, to discuss his conception. Mr. Charlson had previously consulted with Mr. Darr about the feasibility of building a high-torque, low-speed hydraulic motor. He, therefore, felt that Mr. Darr could build it, if he could understand the operation of the commutator valve mechanism. After considerable analysis and careful study, Mr. Darr concluded that the mechanism would work.

24. Over a period of 4 to 7 days, Mr. Darr proceeded to build a model which incorporated the commutator valve mechanism and the gerotor. After some modifications and refinements, the orbit motor invention resulted.

25. Mr. Charlson then consulted Merchant & Merchant, a Minneapolis firm which specializes in the practice of patent law, regarding obtaining patent protection for an orbit motor.

26. After conducting a patent novelty search, Merchant & Merchant recommended that a patent application be prepared for filing in the Patent Office. An application, Serial No. 590,314, was filed on June 8, 1956.

27. The conception and reduction to practice of the orbit motor was done by Mr. Charlson on his own time and at his own expense. Mr. Charlson personally approached Harold Darr for design consultation and model work on the invention, and he also personally retained the patent firm of Merchant & Merchant.

28. On January 28, 1958, United States Letters Patent No. 2,821,171 issued in the name of Lynn L. Charlson. In October 1957, upon learning that the Patent Office would eventually

issue him a patent, Mr. Charlson met with Mr. Darr and they evaluated the commercial applications of the orbit motor and concluded that it had "stupendous" applications. They felt that there was a large market for a motor which could generate high torque at low speeds, without the necessity of a speed reducer.

29. Mr. Charlson did not personally make any inquiries concerning the exploitation of the orbit motor patent by companies active in the fluid power field. However, Mr. Darr did make inquiries of companies he was familiar with. In addition, Mr. Darr asked the Nichols Company, the manufacturer of the gerotor, about companies which would be best suited to market the orbit motor.

30. Mr. Charlson decided in October of 1957 to sell his orbit motor patent when it issued.

31. Mr. Charlson's decision to sell his patent was based on a variety of reasons, including his belief that he should keep his invention as an independent asset, separate from his company, Char-Lynn, insofar as his estate was concerned. In this manner, the potential value of the orbit motor to Mr. Charlson or his estate would not be affected by possible adverse results of Char-Lynn's operations. Mr. Charlson was also concerned that Char-Lynn, with its limited capabilities, would not be able to adequately exploit the full potential of the motor. In addition, Mr. Charlson was concerned if the patent was retained by him personally, that he might somehow be forced to include it in a sale of Char-Lynn. Finally, Mr. Charlson wanted to sell the patent in order to avoid adding to his own personal heavy workload at Char-Lynn.

32. Adam E. Zatarga (hereinafter referred to as "Zatarga"), a senior partner in the international accounting firm of Peat, Marwick, Mitchell & Co., was the principal accountant and tax adviser for Charlson personally and for Char-Lynn beginning in 1950. Zatarga developed a fairly close relationship with Mr. Charlson.

33. Mr. Charlson was advised by Zatarga in 1957 and by his lawyer, Ward B. Lewis, Esq. (hereinafter referred to as "Lewis"), that by selling his patents to a third party he

would be entitled to treat the proceeds as capital gains rather than ordinary income. Mr. Charlson in late 1957 and early 1958 carefully considered the question of to whom he could sell his motor patent.

34. Zatarga further advised Mr. Charlson in 1957 that if the Charlsons would make a timely gift of 7 percent of the Char-Lynn stock to their daughter, Mrs. Donna Herzog, who at that time owned 13.5 percent of the stock, pursuant to a gift program designed to give her a 33⅓ percent interest, that Mr. Charlson could sell his patent to Char-Lynn with the same tax results and benefits as would occur from a sale by Charlson to an unrelated party.

35. The possibility of selling his patent to Char-Lynn did not appeal to Mr. Charlson and he rejected it.

36. Mr. Charlson did not want to sell his patent to a large corporation, even though such a corporation could probably develop and exploit the patent faster than other prospective purchasers, because the orbit motor disclosed by the patent had not been developed or produced. Charlson believed that he would not receive a fair price from a large corporation for his untried orbit motor patent.

37. Mr. Charlson also considered selling his patent to a professional patent licensing and exploiting company, but decided against it.

38. At a luncheon with Mr. Lewis in early 1958, Mr. Charlson informed Lewis that he wanted to sell his motor patent to a group of his business associates. This group was to consist of Harold Darr; Lewis; Mrs. Beverly Scott, Charlson's secretary and administrative assistant at Char-Lynn; and Raymond O. Jensen, comptroller of Char-Lynn.

39. These individuals were selected because they were trusted, long-time business associates of Mr. Charlson and had contributed to the growth of Char-Lynn. Each of the selected individuals had diverse talents that would be helpful to a new corporation. Particularly, Lewis had proven legal experience, Darr had engineering and design capabilities, Scott had administrative and coordinating experience, and Jensen had a good business background.

40. Lewis suggested that Mr. Charlson include his son-in-law, Mr. Herzog, who was employed by a small Minneapolis

advertising agency which was doing some business with Char-Lynn, into the group. Mr. Charlson turned down the suggestion, since he did not want any member of his family to be a part of the group.

41. Mr. Charlson suggested that Lewis contact Mrs. Scott and Messrs. Darr and Jensen to determine if they would be willing to organize and invest money in a corporation whose intended purpose was to purchase and exploit his patents. Mr. Lewis agreed to do so.

42. Mr. Lewis contacted the above individuals and they agreed to organize and invest in a corporation to purchase and exploit the Charlson patents, including his orbit motor patent. Lewis informed them that there would be no restrictions or limitations of any kind on their ownership of the Charlson patents.

43. Lewis, subsequent to obtaining the assent of Darr, Jensen and Scott, organized Germane Corporation in the State of Minnesota, and the corporation's certificate of incorporation was issued on September 2, 1958.

44. Mrs. Scott picked the name "Germane" for the new corporation.

45. At the first meeting of the board of directors of Germane Corporation, each of the four individuals paid $300 by personal check for 300 shares of Germane common stock.

46. Germane's articles of incorporation provided for an authorized capital stock of 2,500 shares with no par value. On September 25, 1958, a total of 1,200 shares, at a stated price of $1.00 per share, were initially issued in equal portions of 300 shares each to Lewis, Darr, Jensen and Scott. Lewis told the other three investors that they might have to invest additional funds at a later date.

47. The stock subscription payment of the Germane shareholders was given to Scott who opened the bank account with the checks received.

48. In 1958 the stock originally issued to Lewis was reissued to his wife, Susan E. Lewis, as trustee.

49. When Darr died in 1967, the shares of stock held by his estate were repurchased by Germane in accordance with article IV, section 2, of Germane's bylaws.

Findings of Fact

50. The Germane board of directors at its meeting of November 18, 1968, repealed article IV, section 2 of the Germane bylaws.

51. At all times since incorporation of Germane in 1958 until its dissolution in 1971, the following persons constituted the only directors and officeholders of that company: Raymond O. Jensen, president; Beverly G. Scott, vice-president and secretary; Ward B. Lewis, Esq., vice-president and assistant secretary; and Harold W. Darr, treasurer (while alive).

52. After the incorporation of Germane, Mr. Lewis continued full-time in the private practice of law in Minneapolis, and remained as Char-Lynn's corporate counsel as well as Mr. Charlson's personal attorney.

53. In 1958 Darr was fully engaged in his independent design business in Minneapolis and served about a dozen different companies in the same manner.

After Darr's death in 1967, Jensen took over the position as treasurer of Germane while remaining as that company's president.

54. None of the Germane officers or directors were or are related by blood or marriage to Charlson, his wife Beryl, or their ancestors or descendants.

55. Mr. Charlson never saw the articles of incorporation or bylaws of Germane. Moreover, he never saw any documents or records of Germane at any time during that corporation's existence.

56. Mr. Charlson never owned any Germane stock. Furthermore, none of the stockholders of Germane during its existence ever held stock for Charlson, his wife, or their ancestors or descendants, or as nominees for them.

57. Neither Mr. Charlson nor his wife ever served as an officer, director, or employee of Germane.

58. Neither Charlson nor his wife ever contributed or loaned money to Germane, either directly or indirectly; and neither Germane nor the shareholders of Germane ever paid Charlson or his wife any money other than the money they were entitled to as purchase price for the patents sold to Germane.

59. Germane executed a written patent sale agreement with Charlson on or before September 25, 1958. The agreement was made retroactively effective to January 28, 1958, the date upon which the patent was issued.

60. Lewis, representing Germane, and Merchant & Merchant, an independent patent law firm representing Charlson, drew up the patent sales agreement which transferred all of Charlson's right, title and interest to his various patents and patent applications to Germane. There were many price discussions during the course of the sales transaction.

61. Under the patent sale agreement, Charlson sold the following patents and patent applications then owned by him to Germane:

United States Patent 2,800,922 issued July 30, 1957;
Canadian Patent 550,525 issued December 24, 1957;
United States Patent 2,821,171 issued January 28, 1958;
Canadian application S.N. 712,960 filed August 15, 1956;
Great Britain Patent 787,499 issued August 24, 1956;
French Patent 1,157,539 issued September 3, 1956;
German application C 14 947 Ia/88b filed June 5, 1957;
Italian Patent 559,416 issued March 21, 1957;
Swedish application 7890/56 filed August 28, 1956;
Australian Patent 211,118 issued September 6, 1956;
Brazilian application 96689 filed August 27, 1957;
Japanese application 20302/1957 filed August 17, 1957;
United States application S.N. 691,458 filed October 21, 1957; and
Canadian application (counterpart of U.S. application 691,458).

United States Letters Patent No. 2,821,171, which covered the Charlson motor, was the principal patent transferred under this agreement.

62. The patent sale agreement expressly recited that Charlson transferred "his entire interest" in the patents and patent applications sold.

63. Germane promised to pay Charlson 80 percent of the annual royalties it received from licensing as the purchase price for the patents. Accountings were to be made quarterly.

64. Paragraph 6 of the patent sale agreement provided that Germane should "exercise proper quality control" to insure suitable manufacture of the motor and other devices

covered by the patents which were transferred under this agreement. Germane agreed to—

> * * * submit upon request samples of said devices to Charlson for inspection and * * * [to] adhere to recommendations with regard to maintaining proper quality control.

In the event of an infringement suit, the patent sale agreement provided—

> * * * the parties may mutually agree jointly to prosecute the alleged infringement, and the manner in which the expense of such prosecution shall be shared. However, in the event such agreement is not reached, either party hereto may be permitted to prosecute and in the event such prosecution is successful, the monies received as a result of such prosecution may be retained as his own property by the party financing such prosecution. [Patent sale agreement, para. 8.]

A similar provision governed the defense of infringement suits. A provision governing termination of the agreement allowed Charlson the "right to cancel and to terminate" the patent sale upon default of Germane to make the required payments to Charlson. Germane had a right to cure the default. (Patent sale agreement, para. 9.)

65. Charlson did not, either before or after the sale of the patent, enter into an understanding with Germane, its shareholders, directors, officers, or employees, that he would control the decisions of Germane with regard to licensing the motor patent.

66. Charlson never attended the formal or informal meetings of Germane shareholders or directors. However, Charlson was aware from time to time of license applications pending before Germane.

67. The four members of Germane decided upon licensing applications and other business matters themselves. Sometimes they would individually or in small groups discuss license inquiries of Germane with Charlson; they respected and oftentimes followed his business and technical advice.

68. Salaries were paid by Germane to its officers and employees, including a Mr. Doyle, its patent attorney. Only Germane shareholders ever received the profits of Germane.

69. As a result of its operations, Germane reported the following transactions for the tax year indicated for purposes of the federal corporate income and personal holding company taxes:

Tax Year	Gross Royalty Income	Percentage Paid to Charlson	Officers' Salaries	Dividends
1958	$63, 625. 48	$50, 900. 38	$8, 100. 00	$2, 463. 00
1959	60, 720. 82	48, 576. 65	10, 800. 00	----------
1960	61, 305. 14	43, 044. 11	10, 800. 00	----------
1961	97, 193. 98	77, 755. 19	10, 800. 00	3, 423. 04
1962	145, 867. 58	116, 695. 06	10, 800. 00	10, 054. 55
1963	165, 863. 20	132, 670. 56	10, 800. 00	10, 529. 06
1964	297, 172. 06	237, 737. 65	10, 800. 00	27, 204. 64
1965	425, 661. 09	340, 528. 88	10, 800. 00	38, 209. 49
1966	659, 712. 51	527, 770. 01	14, 850. 00	54, 648. 44
1967	609, 404. 52	487, 523. 61	22, 000. 00	46, 016. 81
1968	783, 154. 91	626, 523. 93	22, 875. 00	61, 026. 84
1969	1, 100, 028. 20	880, 202. 56	20, 325. 00	86, 524. 25
1970	812, 455. 73	649, 164. 59	10, 050. 00	70, 939. 70

70. Minutes were kept by Lewis of Germane's directors' meetings. The corporate minutes were retained at Lewis' law office. The ledger and other financial books of Germane were kept by Jensen and were in his custody.

71. Darr was in charge of finding licensees for Germane. He also served as Germane's engineer-technician and monitored its various licensing arrangements, chiefly that with Char-Lynn, to insure that manufacturing was being carried out in accordance with the teaching of the patent.

72. Mrs. Scott kept all administrative records of Germane, except the financial records and corporate minutes book. She also handled the payroll, wrote and signed checks, and answered correspondence.

73. Germane was not a full-time job. Mrs. Scott and Jensen each devoted about 15 hours per week on the average to Germane business. Darr played a minimal part in the functioning of Germane. Lewis maintained his private practice in addition to handling Germane's legal matters.

74. At the time of the patent sale, Charlson did not impose as a condition of sale, implied or otherwise, that Germane grant Char-Lynn a license to manufacture the orbit motor. Nor did Germane's directors and officers understand this to be a condition of sale.

75. Mr. Lewis had mentioned to the other members of Germane, at a preincorporation meeting, that Char-Lynn was willing to take a license if Germane wished to give one.

76. At the time of sale, Germane granted Char-Lynn a nonexclusive license to manufacture motors in the United States and to sell them worldwide. The directors of Germane decided that Char-Lynn was a logical choice for a licensee, because of its experience and financial stability. The fact that Mr. Charlson, Char-Lynn's president, was the inventor of the orbit motor was also an important consideration.

77. At no time did Mr. Charlson dictate that Germane should or should not grant a license to a certain company. Charlson did supply business and technical advice to Germane upon request, and Germane valued this advice.

78. No applicant was ever denied a license by Germane because it might possibly compete with Char-Lynn. Germane licensed two potential, though not significant, competitors of Char-Lynn in the United States. These were Lamina Corporation and Ross Gear Company (later acquired by TRW, Inc.).

79. Germane did not actively engage in the solicitation of licenses prior to 1964, because the motor was unproven in marketability and demand.

80. Germane did receive mail inquiries from interested parties about licenses. Some of the inquiries were mistakenly addressed to Char-Lynn. When this happened, Mrs. Scott would accept the mail on behalf of Germane for consideration and processing.

81. Germane did not conduct a brochure advertising campaign to obtain licensees. The record shows that Germane was unfamiliar with the intricacies of obtaining patent licensees.

82. Decisions to license were made by the Germane board of directors. The granting of a license required approval of a majority of the board of directors. Charlson never participated in these decisions.

83. The decisions to license were made according to certain criteria. Germane did not want to license a large company, because it might shelve the patent and work around it or otherwise take advantage of Germane. Germane was interested in medium-size companies with a good financial back-

ing. Germane also did not want to grant licenses which would merely result in more licenses sharing the same existing motor market. The fact that the Nichols Company's (the only successful manufacturer of gerotors) production was substantially consumed by Char-Lynn also was a limiting factor in the number of licensees. Germane's practice to some extent involved protection of existing licensees.

84. Following its licensing of Char-Lynn, Germane entered into a license agreement with Danfoss A/S, a Danish corporation. Danfoss was one of the larger companies in Denmark, had marketing organizations throughout Europe, was well financed, and was interested in diversifying into the hydraulics business.

85. Danfoss originally directed its license inquiries to Char-Lynn. Mr. Charlson, as president of Char-Lynn, forwarded these requests to Germane. At the same time Mr. Charlson wrote to advise Danfoss that the patents were held by a separate company and that he was informing Germane of Danfoss' inquiries.

86. A Danfoss representative, Arne Enmark, visited the Char-Lynn plant in the summer of 1961, but did not see Charlson, who was out of town.

87. Charlson spoke with Char-Lynn employees, Messrs. Firth and McDermott, who met with the Danfoss representative. McDermott felt that since Char-Lynn had a worldwide nonexclusive license from Germane, that Danfoss should be licensed only if Char-Lynn could not handle Danfoss' market. On the other hand, McDermott felt that if Char-Lynn was incapable of supplying motors for the European market that Char-Lynn should attempt to share in the profits from that market through an arrangement with Danfoss. Charlson believed the European market was beyond the capacity of Char-Lynn. McDermott also observed that Char-Lynn and Danfoss could exchange technical improvements each made on the motor.

88. Lewis, representing Germane, visited Danfoss in Denmark. Danfoss wanted to meet and talk to Mr. Charlson before a license was negotiated.

89. After visiting Danfoss, Lewis met with the Germane board of directors and also with Mr. Charlson. Danfoss

wanted the exclusive right to make, use, and sell the motors in Europe and was concerned that Char-Lynn might either erect a factory in Europe or sell motors in Europe. Germane consulted Mr. Charlson on this point, and Char-Lynn agreed to relinquish any rights to manufacture, use, and sell in Europe.

90. In the fall of 1961, the president of Danfoss, Mads Clausen, visited Char-Lynn and Mr. Charlson.

91. In November 1961, Messrs. Lewis and Charlson visited Danfoss in Denmark. Germane and Danfoss entered into a licensing agreement. Char-Lynn and Danfoss entered into a sales agreement, providing that, during the period required by Danfoss to tool up, Char-Lynn would sell motors to Danfoss for distribution in the European market.

92. This licensing agreement contained a quality control provision similar to that in the patent sale. However, in this agreement Germane would exercise the supervision, not Charlson.

93. In order to provide technical assistance to Danfoss under the exclusive sales agreement, Char-Lynn sent Mr. McDermott to Denmark. In addition, Mr. Charlson made several trips to Danfoss to give technical assistance.

94. Mr. Charlson and Germane shared a common interest in the success of Danfoss, since they were to divide the royalties received in accordance with the 80–20 percent split agreed upon at the time of Mr. Charlson's sale of his patents to Germane.

95. After establishing its own production facilities, Danfoss returned 2,000 motors to Char-Lynn since they were no longer needed as inventory.

96. During the time that Germane owned the Charlson patents, Danfoss paid Germane $901,289.10 in royalties on motors manufactured in Denmark.

97. In November 1961, Germane granted Moore Hydraulics Pty., Ltd., a license to make, use, and sell the orbit motor for the territories of New Zealand and Australia. The license was substantially similar to the Danfoss license, except no minimum royalty payment was imposed.

98. Mr. Jensen executed the patent licensing agreement on behalf of Germane. Charlson executed a motor sales agree-

ment on behalf of Char-Lynn which was similar to the one executed with Danfoss. All negotiations had been handled by Messrs. Jensen, Charlson, and Mrs. Scott.

99. Moore Hydraulics never manufactured motors, because it did not believe the potential market would justify the estimated capital expenditures. Instead, it sold motors that it received under a Char-Lynn sales agreement which was executed concurrently with the Germane license.

100. Germane did negotiate with Ross Gear Company for a United States license. However, no agreement was ever executed because of Ross Gear Company's refusal to pay Germane a 5 percent royalty.

101. In a later year, Ross Gear Company, which had by then been acquired by TRW, Inc., manufactured a steering device which Char-Lynn felt infringed the orbit motor patent. Germane, Char-Lynn, and Charlson filed a joint infringement suit. The suit was settled by the licensing of TRW, Inc., under the patent to make a steering device of a specified design.

102. In 1963, Viking Pump Company applied for a license from Germane. The license was refused because of Viking's small size and lack of manufacturing capability.

103. In April 1964, Lamina, Inc., entered into a licensing agreement with Germane. The license permitted Lamina to manufacture a motor smaller than Char-Lynn was currently building, and restricted its use to drilling equipment which Lamina made. In particular, Lamina wanted to make portable drills that were small and could drill holes in inaccessible areas without excessive straining by a single individual. The license permitted the manufacture of 3–4 horsepower motors for this purpose only. Char-Lynn made physically larger motors in the 0–10 horsepower range.

104. Mr. Charlson was not only present at the April licensing conference with Lamina, but did most of the talking and was the dominant voice.

105. About the time of the April 1964 license, Char-Lynn's marketing division was concerned that Lamina might compete with Char-Lynn's market. Mr. Charlson wanted Germane to grant a broad license, because he wanted a manufacturer in the machine tool industry. Germane granted a

restrictive license, because it did not want two licensees sharing 10 percent of the market area while 90 percent of the potential market remained unoccupied. Germane felt that permitting Lamina to share the market which Char-Lynn was currently exploiting would only result in price cutting and thus reduce Germane's profits.

106. The Lamina motor could not compete with the Char-Lynn motor if Lamina obeyed the terms of its license. However, the transcript shows that Lamina could not profitably make motors under the technical restrictions imposed.

107. Under the April license, Lamina manufactured two small motors for use on its portable drill. The smaller "A" motor was 1¾ inches in diameter and generated 0–4 horsepower; the larger "B" motor was 2⅜ inches in diameter and generated 0–5 horsepower. The Lamina "A" and "B" motors could put out as much as 10 horsepower, however, at that level the heat generated by the motors was excessive. In order to cope with the excessive heat, a suitable heat exchanger was needed for Lamina motors that operated in these hyper-horsepower ranges. Additional design differences existed between the Char-Lynn 10 horsepower motor and the Lamina motors when they operated at 10 horsepower. Lamina's motors ranged from $195 to $300 as opposed to about $85 for the Char-Lynn motor.

108. Lamina's drill did not sell very well. Lamina customers began asking if they might purchase the motor only. Such sales, although not authorized by the April 1964 agreement, were informally permitted for a time.

109. During the period when Lamina was making motor sales, it requested from Germane and Char-Lynn a broader license to manufacture and sell. In particular, it wanted the severe restrictions on motor specifications in the April 1964 agreement revised.

110. The criterion used by Germane in denying these requests, except in cases of emergency or an improvement in motor design, was whether a Char-Lynn motor could do the job.

111. During the period when Lamina was making direct motor sales under the April 1964 agreement, Char-Lynn licensed Lamina to use the "Orbit" trademark and the Char-

Lynn market distributors in hopes of improving Lamina's sales. Char-Lynn reserved the right to terminate the agreement, if the Lamina motor did not meet Char-Lynn standards.

112. In 1967 McDermott came across a trade journal in which Lamina was advertising its motors, contrary to the informal agreement with Mr. Charlson, for general application. These sales were discovered to be cutting into the Char-Lynn market.

113. Charlson was disturbed that the Lamina motor was not up to Char-Lynn standards. Charlson pointed out to Lamina that Lamina's advertisements would lead the reader to believe that the smaller Lamina motor with the trademark "Orbit" could be used at the same relatively low pressures as the Char-Lynn motor. In actuality, the operation of the Lamina motor required extremely high pressure and a heat exchanger to remove the excessive heat that was generated by the motor during operation.

114. Mr. Charlson revoked his informal agreement with Lamina pertaining to direct sales of the orbit motor.

115. Mr. Charlson directed Mr. McDermott, Char-Lynn's product manager for hydraulic motors, and Doyle, patent counsel of Germane and Char-Lynn, to draft a new license agreement between Germane and Lamina. The agreement would permit Lamina to manufacture hydraulic motors outside the range of the Char-Lynn motor. The horsepower output of a hydraulic motor depends, among other things, upon the rate of flow of the oil through the motor and the amount of pressure used to drive the oil through the motor. McDermott drafted the paragraphs 2 and 3 specifications of a draft of a license agreement with restrictions upon the pressure and the oil flow rate, which would have limited Lamina to a fractional motor of about ¾ horsepower for each gallon of oil passing through the motor. A motor manufactured by Lamina under these specifications would not have been competitive with the Char-Lynn hydraulic motor and would have been restricted to very special applications.

116. Mr. Doyle acted as house patent counsel for both Char-Lynn and Germane in these negotiations. He peri-

odically billed Char-Lynn for work he did on behalf of Germane. Germane then reimbursed Char-Lynn for such legal fees. Doyle saw no conflict of interest in his position.

117. In October 1967 Char-Lynn submitted to Lamina a list of operating specifications for a hydraulic motor from the specifications drafted by McDermott. Char-Lynn stated that it was willing to accept these characteristics as a change from the original license agreement between Lamina and Germane. Lamina protested that the high pressure and extremely low volume limitations would prevent it from selling any motors built under the proposed specifications.

118. In November 1967 Lamina officials met with Charlson, Doyle, and Jensen at the new Eaton Prairie plant of Char-Lynn to discuss a new license to manufacture and sell motors that would not be restricted to drilling apparatus.

119. The conference discussions focused on the operating characteristics of the motor to be manufactured and sold by Lamina which would be acceptable to all concerned.

120. Charlson was the dominant figure at this conference and did most of the talking.

121. These negotiations produced no agreement.

122. In December 1967 Mr. Richardson, a hydraulic specialist for Lamina, visited the new Eaton Prairie plant of Char-Lynn in an effort to obtain a workable license for Lamina. Mr. Charlson told Mr. Richardson that he was not in a position to grant a license. Mr. Richardson next met with Mrs. Scott. After 4 days at Eaton Prairie, Mr. Richardson was notified by Mrs. Scott that Germane would tender a workable license to Lamina.

123. Mr. Charlson again asked Messrs. McDermott and Doyle to collaborate in formulating restrictions on Lamina's new license. The restrictions finally agreed upon in the new license, accepted by Lamina, were considerably less confining and allowed Lamina to produce a 5–6 horsepower motor, which would give significant competition to the Char-Lynn motor. Their second agreement was consummated in December 1967.

124. Mr. Lewis did not participate in the negotiations or drafting of this second license. Jensen and Doyle represented Germane.

125. As desired by Charlson, this second licensing for Lamina was broader than the prior 1964 license and encouraged Lamina to manufacture and sell its motors in the machine tool field. Char-Lynn sold primarily in the agricultural equipment market.

126. Germane and Char-Lynn permitted Lamina to sell its old and very large inventory of hydraulic motors which were manufactured in violation of the restrictions of the 1964 license and still not permitted by the 1967 license. These motors could be sold only to customers of Lamina where the Char-Lynn motor could not be used.

127. Mr. Doyle personally evaluated Lamina's requests to sell or referred them to the sales or engineering department of Char-Lynn. He considered the waiver requests as closely related to the sales rights of Char-Lynn as well as to the licensing rights of Germane.

128. Most of the requests by Richardson submitted to Doyle involved either machine tool use or special applications where physical space limitations precluded the use of a Char-Lynn motor. Such requests were granted. Some design changes requested by Lamina on its motor within the authorized power limitations under the 1967 license were also approved.

129. Beginning in 1958 and until its sale in 1970, Char-Lynn manufactured only one model of motor which could be varied to produce between 0 and 10 horsepower. Production of the patented orbit motor required the use of a gerotor. Char-Lynn would vary the width (as opposed to diameter) of the gerotor to produce motors of different horsepower.

130. Char-Lynn purchased its gerotors from the Nichols Company of Boston. The Nichols Company was the only commercial source of suitable gerotors in the United States, and it manufactured only the so-called "H" gerotor in significant quantities. Char-Lynn used the "H" gerotor in its motors.

131. No other company could manufacture gerotors to the required tolerances in sufficient quantities. Gerotors with the required tolerances are very difficult to make efficiently. Char-Lynn could not efficiently make them, although it tried. A Japanese company said it could make suitable gerotors, and

Germane considered granting them a license to manufacture the entire motor. However, the Japanese gerotor proved to be inferior and usable in low pressure pumps, but not in a high pressure motor.

132. TRW, Inc., and Lamina also purchased gerotors from the Nichols Company. Lamina, however, purchased a smaller size gerotor than TRW, Inc., or Char-Lynn.

133. At the time Germane bought the patent from Charlson in 1958, and many times thereafter, Nichols represented to one or more of Germane's directors and shareholders that it would be able to supply all quantities needed by prospective licensees, because it was building new plants and bringing in new machinery.

134. However, serious and unforeseen problems in obtaining an adequate supply of gerotors from Nichols developed. Char-Lynn, Nichols' largest customer, had difficulty in obtaining an adequate supply of "H" gerotors because of production shortages at Nichols or poor delivery schedules by Nichols. Lamina experienced similar difficulties with the gerotors it purchased.

135. Nichols complained about Char-Lynn's practices in the ordering of gerotors. First, there would not be enough gerotors and Nichols would go into full production schedules; then half-way through the year, Char-Lynn would say it did not need any more.

136. In 1967 Nichols expanded by opening a new plant in Portland, Maine. It doubled Nichols' capacity. However, the supply problems continued with the "H" gerotors.

137. Char-Lynn never supplied more than 2 to 5 percent of the potential market due to the lack of gerotors. Moreover, because of the inability to obtain different size gerotors, Char-Lynn's production was limited to manufacturing motors using the "H" gerotor.

138. In the period 1964–1970, Germane did not actively solicit licenses because of the shortage of gerotors.

139. In the latter part of 1968, after Charlson had developed a serious disease, Charlson and his wife decided to sell Char-Lynn.

140. Charlson never informed any of the Germane directors of his decision to sell Char-Lynn. Mrs. Scott, through

her position at Char-Lynn, became aware that Charlson was considering selling out.

141. Charlson hoped that Germane would continue to consider the opportunities for expanding its licensing program.

142. In late 1969, Germane's shareholders decided to sell Germane, either through a sale of assets or a sale of stock.

143. The Germane shareholders did not inform Charlson that they were seeking to sell their interest, nor did they inform any of Germane's licensees.

144. Germane employed and paid Dan Stice, a patent attorney, to represent Germane in finding a buyer and negotiating the sale of Germane.

145. Stice reviewed Germane's patent portfolio and was aware that Char-Lynn was the principal licensee of Germane.

146. In February 1970 Lewis and Stice visited New York City to confer with parties interested in the purchase of Germane. A topic raised at this conference was whether the prospective purchasers would grant licenses to businesses in competition with Char-Lynn. The prospective purchasers indicated that they could not, for tax and antitrust reasons, guarantee in writing that such a license would not issue.

147. Stice contacted Eaton Corporation, a possible purchaser. In July 1970 Lewis and Stice visited Eaton Corporation in Cleveland, Ohio. Eaton Corporation expressed considerable interest in Germane's patents.

148. Eaton Corporation eventually acquired Germane. Neither Charlson nor Char-Lynn in any way participated in these negotiations.

149. In August 1970 Mrs. Scott became aware of Charlson's intention to sell Char-Lynn.

150. In December 1970 Charlson was engaged in very serious negotiations for the sale of Char-Lynn stock. Included among the prospective purchasers was Sperry Rand Company, to whom Charlson had made a tentative decision to sell his stock.

151. When Mr. Charlson was on the verge of consummating the sale to Sperry Rand Company, he was approached by Eaton Corporation, who was still negotiating with Germane, with an offer to purchase Char-Lynn.

152. Because of Eaton's interest in acquiring Mr. Charlson's rights to the remaining purchase price payments due to him under the original patent sales agreement with Germane, and, as well, Char-Lynn, Eaton's offer to Mr. Charlson was better than Sperry Rand's.

153. The sale of Char-Lynn was negotiated in part by Mr. Doyle. The sale of Charlson's residuary rights was handled by Mr. Bert B. Rand, Charlson's private counsel.

154. Eaton Corporation purchased the stock of Char-Lynn and Charlson's residuary rights. The residuary rights alone cost Eaton Corporation about $8 million.

155. The transactions between Eaton Corporation and Germane and between Eaton Corporation and Char-Lynn and Charlson were closed at the same time in December 1970.

156. Eaton Corporation could have refused to close with Germane, if Charlson decided not to sell his residuary rights.

157. Pursuant to the terms of the patent sale agreement between Germane and Charlson, Germane computed and paid over the following amounts to Charlson for the years in issue: 1961—$58,032.74; 1962—$99,523.72; and 1963—$124,896.56.

158. In filing their joint federal income tax returns for the years 1961, 1962 and 1963 (prepared by Peat, Marwick, Mitchell & Co.), Charlson and his wife reported these payments from Germane as long-term capital gain.

159. On or about November 9, 1966, Charlson and his wife paid to the Internal Revenue Service the sums of $32,012.56 in payment for an asserted deficiency for the year 1961 (including interest), $56,211.67 in payment of an asserted deficiency for the year 1962 (including interest), and $66,274.81 in payment of an asserted deficiency for the year 1963 (including interest).

160. On or about September 13, 1968, Charlson and his wife filed with the Internal Revenue Service their timely refund claims for taxes unlawfully assessed for the following years and for the following amounts: 1961—$25,164.40; 1962—$46,374.03; and 1963—$57,523.38.

161. These claims for refund were rejected on or about March 26, 1969, with the Internal Revenue Service taking the position that the payments should be taxed at ordinary income rates and not at capital gains rates. The Internal

Revenue Service based its position on the decision of the Tax Court in *Myron C. Poole*, 46 T.C. 392 (1966).

162. The parties to this action have stipulated that should Charlson prevail, he is entitled to recover the amounts set forth in finding 160, *supra*.

CONCLUSION OF LAW

Upon the foregoing findings of fact and opinion, which are adopted by the court and made a part of the judgment herein, the court concludes as a matter of law that plaintiffs are entitled to recovery of $32,012.56 for 1961; $56,211.67 for 1962; and $66,274.81 for 1963, along with interest for each of the years as provided by law from the date of payment.

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527 F.2d 1191

SAMUEL C. WATHEN, JR. v. THE UNITED STATES

[No. 249-69. Decided December 17, 1975*]

ON THE PROOFS

Civilian pay; dismissal; violation of Internal Revenue Service Rules of Conduct; criminal proceedings.—Plaintiff, a former Internal Revenue agent and a preference eligible veteran, was removed from his position, effective June 18, 1965, in order to promote the efficiency of the Service on the charge that he violated the Service's Rules of Conduct in a manner which brought discredit upon the agency. On May 9, 1965 plaintiff was arrested and charged with murder in the fatal shooting of a woman. Sensational accounts of the incident were published in newspapers, all of which highlighted plaintiff's employment as an Internal Revenue agent. In December 1965 the Circuit Court for Montgomery County, Maryland, acquitted plaintiff of homicide by reason of temporary insanity, and committed him to a state hospital until March 29, 1966 when the court declared him sane and released him. On April 6, 1966 plaintiff sought restoration to duty and subsequently filed a written appeal; the CSC Examining Office and the Board of Appeals and Review later affirmed the agency's determination that plaintiff's appeal was untimely, but without reaching the merits of the charge and specification. Plaintiff then appealed to the Civil Service Com-

*See the order at 368 denying plaintiff's motion for rehearing pursuant to Rules 7(d) and 151(b), with dissent by *Judge* Davis, and with statement by *Judge* Nichols concurring in the result.

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missioners requesting review of his removal on the merits; the request was allowed and the case was returned to the CSC Appeals Examining Office, whose Chief later sustained the agency's removal action, finding no procedural errors and affirming that plaintiff had been removed for such cause as would promote the efficiency of the Service. This disposition was affirmed by the CSC Board of Appeals and Review. Plaintiff filed suit in this court seeking to recover the salary he would have earned from March 29, 1966 to date of judgment, asserting that his removal and subsequent refusal of restoration to duty were contrary to law and void. It is *held* (1) that the agency's removal of plaintiff on the basis of the charge and specification was in good faith and was not arbitrary, capricious or unsupported by substantial evidence. There is substantial record evidence to support the finding that the shooting brought discredit on the Service. Furthermore, the record does not show that plaintiff's removal was so excessively precipitous as to constitute arbitrary, capricious action or an abuse of agency discretion. It is also held (2) that since the agency removed plaintiff in a legally proper manner in view of what it in good faith judged to be such cause as would promote the efficiency of the service, the agency could also properly refuse to reinstate plaintiff upon his request. The court points out that in keeping with settled principles of law, it has declined to base its opinion on the debatable question of whether the killing, faultless in legal contemplation, may be deemed such cause for removal as promotes the efficiency of the service. Plaintiff is not entitled to recover and the petition is dismissed.

Civilian pay; Court of Claims jurisdiction; administrative or executive decisions; review of by court.

[1] This court limits its review of administrative action in civilian pay cases to a determination of whether the adverse action disclosed by the administrative record or by a de novo trial, or both, is illegal because it violates applicable statutes or regulations, or is demonstrably in bad faith or malicious because it is arbitrary, capricious, or devoid of substantial evidence to support it.

United States ⇐ 39(11)

Civilian pay; presumptions; official actions of Government officials; presumption of regularity.

[2] In this court's review of an adverse administrative action respecting a Federal employee, the presumption is that the Government officials have acted in good faith. Plaintiff must overcome the presumption of good faith, almost irrefragable proof being required to demonstrate abuse of discretion sufficient to overcome the presumption.

United States ⇐ 36

Civilian pay; dismissal; administrative decision; finality of.

[3] Whether removal of a Federal employee will promote the efficiency of the service is an administrative decision to be determined

within the discretion of the employing agency, and no court has power to upset the action if it is taken in good faith and supported by substantial evidence. Employing agencies and the Civil Service Commission are far better equipped and in a better position to make sensitive judgments of whether and how a dismissal promotes efficiency of the service. It is not within this court's province to pass on the question whether an individual should or should not be employed. The Government's interest in being able to act expeditiously to remove an unsatisfactory employee is substantial.

United States ⇐ 36

Administrative Procedure Act; judicial review of administrative actions.

[4] The Administrative Procedure Act, 5 U.S.C. §§ 701–706, does not govern jurisdiction in the Court of Claims, but merely outlines procedures for judicial review of administrative actions.

Courts ⇐ 448

Civilian pay; Court of Claims jurisdiction; administrative or executive decisions; review of by court.

[5] In this court's review of an administrative action removing a Federal employee to promote the efficiency of the service, it is not necessary that the court find that the agency construction is the only reasonable one or that it is the result the court would have reached had the question been permitted to arise in the first instance in judicial proceedings. It is enough if the decision has a rational basis by the standard enunciated and in the case law relied on here.

United States ⇐ 36

Evidence; hearsay; admissibility of; administrative hearings.

[6] In judicial review of administrative action removing plaintiff to promote the efficiency of the service because he fatally shot his mistress and brought discredit upon the Internal Revenue Service (although he was subsequently found not guilty of homicide by reason of insanity), hearsay can be substantial evidence to support the administrative adjudication. Thus, the existence of newspaper accounts of the shooting and of plaintiff's arrest provide evidence of the homicide, and accounts of plaintiff's employment with the Internal Revenue Service provide substantial evidence from which the employing agency, and ultimately the Civil Service Commission, were entitled in their discretion to conclude that plaintiff's conduct brought discredit upon his employer. Reasonable minds could accept such evidence as adequate to support the stated conclusions at the time they were made.

United States ⇐ 36

Civilian pay; dismissal; arbitrary and capricious action; what constitutes.

[7] Where authorized Internal Revenue Service officials were possessed of substantial evidence tending to prove both the fatal

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shooting of another by one of its employees and consequent immediate discredit to the Service through publicity of such conduct, all tending to impair public confidence in violation of the Service's Rules of Conduct, without prejudice to other proper procedures, it was entirely permissible in the Service's discretion to effect prompt removal based upon such then-available substantial evidence of record even though criminal proceedings were pending involving allegations which gave rise to the prosecution and which also constituted the specifications in the adverse personnel action. Plaintiff's acquittal of the homicide charge by reason of insanity does not require the conclusion that his removal was such excessively precipitous action as to constitute arbitrariness, capriciousness or an abuse of agency discretion. Such action is subject always to the individual's privilege of applying for reinstatement and exhaustion of such rights of administrative appeal as are afforded by applicable statutes and regulations.

United States ⇐ 36

Civilian pay; dismissal; error in; harmless error.

[8] To sustain a recovery based upon administrative impropriety in effecting removal of a Government employee, the latter must demonstrate the manner in which he has been prejudiced thereby. Even if the court entertained the view that the swiftness of plaintiff's removal was error, such error would be harmless since plaintiff, having already been suspended without pay, lost no additional salary by the removal and, moreover, he ultimately secured review of the agency action on the merits before the Civil Service Commission.

United States ⇐ 36

Civilian pay; Court of Claims jurisdiction; administrative or executive decisions; review of by court.

[9] It is not within this court's authority to require the Internal Revenue Service to withhold an employee's removal pending conclusion of criminal proceedings against him where the Service's Rules of Conduct for its employees, the regulations and statutes contemplate otherwise and where the Service's discretion has not been shown to have been abused or based on insubstantial evidence in applying the Rules mandating speedy action to accomplish the purpose of maintaining the efficiency of and public confidence in the Service, a purpose unrelated to the merits of the criminal charge or defense.

United States ⇐ 36

Civilian pay; reinstatement; arbitrary and capricious denial; criminal charge, acquittal of.

[10] While prior mental illness bars neither initial employment with the Federal Government nor reinstatement, so long as the impediment to health has been removed, acquittal of a criminal charge based upon a plea of legal insanity does not bar the employing

agency from denying reinstatement, where such denial violates no statute or regulation and is neither arbitrary, capricious, nor an abuse of discretion.

United States ⇐ 36

Civilian pay; dismissal; charges and reasons for dismissal; Court of Claims jurisdiction.

[11] It is not within the jurisdiction of this court to inquire into the guilt or innocence of a plaintiff as to the charges upon which he was removed from office.

United States ⇐ 36

Civilian pay; dismissal; authority to dismiss; generally.

[12] The power of removal from Federal employment is incident to the power of appointment.

United States ⇐ 36

Civilian pay; administrative discretion; penalties; generally.

[13] The appropriate penalty to impose upon a Federal employee for infraction of an agency's rules is within the discretion of the agency subject to review on the merits by the Civil Service Commission and subject to judicial review on a more limited basis for procedural regularity and abuse of administrative discretion and bad faith.

United States ⇐ 36

John I. Heise, Jr., attorney of record, for plaintiff.

LeRoy Southmayd, Jr., with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Before COWEN, *Chief Judge*, LARAMORE, *Senior Judge*, and BENNETT, *Judge*.

BENNETT, *Judge*, delivered the opinion of the court:

Plaintiff, a former Internal Revenue agent and preference eligible veteran, seeks back pay and reinstatement asserting that both his removal from the service and a subsequent refusal of reemployment were contrary to law and void. This case, rather unusual on its facts, is before us on defendant's appeal from the opinion and conclusion of law by Trial Judge Philip R. Miller.[1]

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[1] We adopt by reference all of the findings of the trial judge, no exceptions having been taken to them by either party. The findings, which have been furnished to the parties, are not reprinted here as those necessary to the decision are included in the opinion. We reverse his conclusion of law and hold for defendant.

At all relevant times prior to May 9, 1965, plaintiff was employed in Washington, D.C., in the National Office of the Internal Revenue Service, as a GS–12 tax law specialist. He was one of 10 agents in the Earnings and Profits Section, Corporation Tax Branch, Tax Rulings Division. In May 1965, plaintiff, age 41, had been separated from his wife for about 3 years, each having informal custody of two of their four children. A divorce was contemplated at such time as his wife's consent could be secured. For the prior 16 months, plaintiff and two of his children lived in Rockville, Maryland, with one Winifred O. McLaughlin, an Irish alien, whom plaintiff wished to marry as soon as feasible. Plans were made for a move to California, and to that end plaintiff had made application for a transfer to the IRS appellate division office located in San Francisco.

On Mother's Day, Sunday, May 9, 1965, at about 3 p.m., plaintiff and Miss McLaughlin set out by car for Friendship Airport, near Baltimore, Maryland, where she was to depart for San Francisco alone. While the car was on the Capital Beltway in Silver Spring, Maryland, for unknown reasons an altercation took place between them. They left the car, whereupon plaintiff seized a 4-barreled Derringer and killed her with two shots as she sought to flee across the Sligo Creek golf course.

At the scene, Montgomery County police arrested plaintiff, pistol in hand, who offered no resistance. The slaying was witnessed by passing motorists. Authorities placed a charge of murder against Mr. Wathen and held him without bond at the Montgomery County jail. Sensational, front-page publicity ensued. No fewer than five articles in three Washington, D.C., newspapers appeared shortly after the shooting, two of which exhibited a picture of plaintiff and victim and all of which highlighted his employment as an Internal Revenue agent. There was trial testimony by IRS personnel to the effect that accounts were carried on local radio and television news programs. IRS officials assigned a special inspector to ascertain the facts.

Under date of May 11, 1965, the inspector filed his report reciting that the Chief of Detectives of the Montgomery County Police Department had advised that Mr. Wathen had

been arrested and charged with Miss McLaughlin's murder and that he was currently being held without bond. On the same day the Director of the Tax Rulings Division, Internal Revenue Service, notified plaintiff by letter of proposed adverse action, namely, suspension from duty without pay in order to promote the efficiency of the service pending further investigation and adjudication.[2] Plaintiff was represented by a lawyer at the time but no papers were filed opposing such proposed action. Effective May 18, 1965, plaintiff was suspended without pay. The record shows that the suspension was based upon the fact that plaintiff had been arrested and charged with murder.

On May 14, 1965, the Director, Tax Rulings Division, again wrote to plaintiff informing him of further proposed adverse action. In this letter the Director undertook to initiate removal proceedings, and we deem the precise wording of the charge and specification to be sufficiently important to set it out in full below.[3] To us it is clear that while

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[2] The Lloyd-LaFollette Act, 5 U.S.C. § 652 (1964), provides, in pertinent part:

"No person in the classified civil service of the United States shall be removed or suspended without pay therefrom except for such cause as will promote the efficiency of such service and for reasons given in writing. * * *." The Veterans Preference Act of 1944, 5 U.S.C. § 863 (1964) [now 5 U.S.C. §§ 3315, 7512, 7701], provides, in part:

"No permanent or indefinite preference eligible, who has completed a probationary or trial period employed in the civil service, or in any establishment, agency, bureau, administration, project, or department, hereinbefore referred to shall be discharged, suspended for more than thirty days, furloughed without pay, reduced in rank or compensation, or debarred for future appointment except for such cause as will promote the efficiency of the service and for reasons given in writing, * * *."

[3] "It is proposed in order to promote the efficiency of the Internal Revenue Service, to remove you from the Service, in not less than thirty (30) calendar days from the date you receive this notice on the basis of the following charge:

"Charge: Violation of Section 1941.4 of the 'Rules of Conduct for Internal Revenue Service Employees' (Revised October 1963).

"(Section 1941.4 states, in part: 'The effectiveness of the Revenue Service in serving the public interest depends upon the extent to which the Service and it's [sic] employees hold the confidence and esteem of the Nation's citizens. This means that each employee must do his part to maintain this confidence and esteem * * *; by conducting himself during and outside working hours in a manner which will bring credit upon the Service; and by observing the spirit, as well as the letter, of the laws and regulations, and Revenue Service and Treasury Department requirements governing employee conduct. Employees whose conduct does not conform to the rules may be removed from the Service or may be the subject of other disciplinary action.')

"Specification: On Sunday, May 9, 1965, you conducted yourself in a manner which brought discredit upon the Internal Revenue Service by fatally shooting Miss Winifred O. McLaughlin."

the *suspension* was premised upon plaintiff's arrest, the charge resulting in *removal* was bottomed on the fatal shooting of Miss McLaughlin.

In due course the time allotted for plaintiff's reply ran out with no response by him to the notice of removal. By letter of June 4, 1965, the IRS notified him of his removal from the service based on the evidence of record as of that date. Such removal actually took effect June 18, 1965. It appears that the record evidence before the agency at the time consisted of the investigative report previously discussed and the media accounts referred to in the testimony, including the various newspaper articles. The notification of personnel action effecting plaintiff's removal stated that it was "because of misconduct which brought discredit upon the Internal Revenue Service, namely committing homicide." It was a considered decision of plaintiff and his then counsel not to respond to the IRS charges while the criminal case was pending.

A Maryland grand jury on June 8, 1965, returned a true bill against plaintiff indicting him for the murder of Miss McLaughlin. At the arraignment on June 23, 1965, a plea of not guilty by reason of insanity was entered, and shortly thereafter the Montgomery County, Maryland, circuit court ordered appropriate psychiatric and psychological examinations. Extensive testing and evaluation followed. It was determined that at the time of the homicide, plaintiff did not know the nature and consequences of his acts nor the difference between right and wrong. The state confessed plaintiff's plea of not guilty. Plaintiff was acquitted of the criminal charge.

The expert testimony at plaintiff's murder trial did not warrant a finding, however, that he was then totally recovered from temporary insanity. Accordingly, the court entered its order of commitment, and plaintiff was remanded to the custody of the Springfield State Hospital, where he remained under treatment from December 8, 1965, until March 29, 1966. On the latter date, the Maryland circuit court once again considered plaintiff's status, this time with the assistance of a jury. The state's medical witness at this trial—the only medical witness—gave it as his opinion that

plaintiff was not then insane and had not been insane at any time during his period of hospitalization. The court declared plaintiff sane, and he was released from custody on the same day.

On April 6, 1966, plaintiff presented himself for duty in the Personnel Division of the Internal Revenue Service.[4] He was then advised that consideration of his restoration to duty could be accomplished only by perfecting a written appeal. For that purpose plaintiff retained counsel who filed the necessary papers. The agency declined to act, noting on June 2, 1966, that plaintiff's appeal was out of time. This action was subsequently approved both by the Civil Service Commission Appeals Examining Office and the Board of Appeals and Review, neither of which reached the merits of the charge and specification on the basis of which plaintiff had been removed for the efficiency of the service.

At this stage plaintiff, by counsel, determined to appeal directly to the Civil Service Commissioners themselves, in a final effort to secure reopening and review on the merits of his removal. By letter dated May 24, 1967, this request was allowed, and the case was returned to the Appeals Examining Office for further development and a new adjudication on the merits. Counsel for the agency and for plaintiff agreed that the case would be submitted on written memoranda without oral hearing.

The submissions to the Appeals Examining Office in plaintiff's behalf included the docket entries of his criminal trial and of the civil proceeding leading to his release from custody. Government counsel adduced no investigative reports, but appended to its papers photocopies of the five clippings from three area newspapers which were published shortly after the shooting.

On April 4, 1968, the Chief of the Appeals Examining Office notified plaintiff of his decision sustaining the removal action of the IRS. The letter opinion found the procedures followed to have been in order, and approved the view on

[4] Thus, plaintiff returned to his former employer seeking reinstatement less than 1 year after Miss McLaughlin's death. His claim for back pay and reinstatement is for the period from April 6, 1966, which he now represents is the date he was ready, willing, and able to resume work for IRS.

the merits that plaintiff had been removed for such cause as would promote the efficiency of the service.[5] On June 28, 1968, the Board of Appeals and Review affirmed this disposition, and in December of that year the Commissioners declined to reopen the case on plaintiff's request. A petition was filed in this court on May 22, 1969. Plaintiff has been privately employed since his release from custody. Evidence adduced at the trial of the instant claim satisfies us that however impaired plaintiff's mental condition was at the time of the slaying, he is now recovered.

I

Plaintiff, through skilled counsel, has made a determined effort here to convince us that we should decide whether he was discharged for such cause as will promote the efficiency of the service. Thus, we are invited to examine the merits of the removal action. Before the precise questions for decision can be delimited, therefore, we must take care to outline the proper scope of judicial review in this case.

It is long settled that this court limits its review of the administrative action in civilian pay cases to a determination of whether the adverse action disclosed by the administrative record or by a *de novo* trial, or both, is illegal because it violates applicable statutes or regulations, or is demonstrably in bad faith or malicious because it is arbitrary, capricious, or devoid of substantial evidence to support it. Good faith of those taking administrative action is presumed. *Boyle* v. *United States*, 207 Ct. Cl. 27, 515 F. 2d 1397 (1975); *Holman* v. *United States*, 181 Ct. Cl. 1, 383 F. 2d 411 (1967); *Finn* v.

[5] The opinion states in part:

"• • • The removal action against the appellant is based upon the fact that he did kill a human being and this act of killing violates standards of conduct required for retention on the rolls of the Internal Revenue Service.

• • • • •

"As noted hereinbefore, there is no allegation in the record that the killing of this human being was done pursuant to authority of law or in self defense. In no sense then can it be a justifiable homicide as attorney for the appellant states. The situation requires no long discussion. The fact of the matter is that an Internal Revenue Agent has killed a human being, and has only escaped punishment by virtue of a plea of insanity. It is a simple conclusion of fact that the unjustified killing of a human being is inconsistent with the standards of conduct for employees in the Federal Service regardless of the state of their mind at the time the killing was committed. Therefore, we find the appellant's removal was for a cause which promotes the efficiency of the service."

United States, 152 Ct. Cl. 1 (1961); *Croghan* v. *United States*, 116 Ct. Cl. 577, 89 F. Supp. 1002, *cert. denied*, 340 U.S. 854 (1950). We have stopped short of approaching the merits of such administrative personnel actions, recognizing that the subject is a matter committed to the discretion of the agency involved:

> Whether a person's discharge will promote the efficiency of the service is an administrative decision to be determined within the discretion of the agency, and no court has power to review the action, if taken in good faith. *Brownell* v. *United States*, 164 Ct. Cl. 406, 408–09 (1964); *Gadsden* v. *United States*, 111 Ct. Cl. 487, 489, 78 F. Supp. 126 (1948). * * *. [*Schlegel* v. *United States*, 189 Ct. Cl. 30, 40, 416 F. 2d 1372, 1378 (1969), *cert. denied*, 397 U.S. 1039 (1970).]

In *Schlegel* the court sitting *en banc* distinguished the facts but declined to approve the view of a divided panel of the United States Court of Appeals for the District of Columbia Circuit, as embodied in *Norton* v. *Macy*, 417 F. 2d 1161 (D.C. Cir. 1969). In the latter case there is some language indicating that a court might review a removal to ascertain whether the cause giving rise to such adverse action is rationally related to the efficiency of the service. 417 F. 2d at 1164. That case did not involve homicide. We think that the dissenting opinion of Judge Tamm more accurately reflects the present state of the law, certainly as it is set down in our own decisions. In a more recent case, speaking for the majority, Judge Tamm wrote that where manslaughter was involved or any case involving charges of serious criminal conduct, the nexus may be presumed between the offense and the removal, between the regulation as applied and the statutory standard permitting removal for the efficiency of the service, and that the reviewing courts should not disturb the discretionary determinations of the agency charged by Congress with primary responsibility in this area. He said, "In all cases involving criminal conduct, the reviewing courts have uniformly upheld the dismissals as promoting the efficiency of the service." *Gueory* v. *Hampton*, 510 F. 2d 1222, 1226 (D.C. Cir. 1974).

In our estimation the agencies and the Civil Service Commission are far better equipped and in a better position to make these sensitive judgments of whether and how a dis-

charge promotes efficiency of the service. It is their prerogative, not ours, to do so. We do not think that we should lightly substitute judicial oversight for that of the executive branch in an area where practical considerations of administration and experience should be paramount and where the executive's prerogative and responsibility is to take expeditious action to insure the efficiency and discipline of the huge federal bureaucracy in the interests of good government.[6] As Chief Judge Jones once put it (*Finn* v. *United States*, 152 Ct. Cl. 1, 7 (1961)):

> * * * it is * * * not within our province to pass on the question whether the plaintiff should or should not be employed. *Wittner* v. *United States*, 110 Ct. Cl. 231. In that case the court said at p. 235 the following:
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> > We are not authorized to determine whether a particular veteran should be employed. * * *. Nor are we concerned with whether an employee should be discharged. That is properly in the hands of the affected department. * * *.

Accord: Crowley v. *United States*, *post* at 415, 527 F. 2d 1176; *Charley* v. *United States*, *post* at 457; *Saracena* v. 206 Ct. Cl. 90, 508 F, 2d 1333(1975); *Greenway* v. *United States*, 175 Ct. Cl. 350, *cert. denied*, 385 U.S. 881 (1966); *Harrington* v. *United States*, 174 Ct. Cl. 1110, 1117

[6] "In the present case, the Government's interest, and hence the public's interest, is the maintenance of employee efficiency and discipline. Such factors are essential if the Government is to perform its responsibilities effectively and economically. To this end, the Government, as an employer, must have wide discretion and control over the management of its personnel and internal affairs. This includes the prerogative to remove employees whose conduct hinders efficient operation and to do so with dispatch. Prolonged retention of a disruptive or otherwise unsatisfactory employee can adversely affect discipline and morale in the work place, foster disharmony, and ultimately impair the efficiency of an office or agency. Moreover, a requirement of a prior evidentiary hearing would impose additional administrative costs, create delay, and deter warranted discharges. Thus, the Government's interest in being able to act expeditiously to remove an unsatisfactory employee is substantial [footnote omitted]." [*Arnett* v. *Kennedy*, 416 U.S. 134, 168 (1974) (Powell, J., concurring opinion).]

See also Bowman Transp. Co. v. *Arkansas-Best Freight Sys.*, 419 U.S. 281, 285 (1974), which, while not a personnel case—as are other cases relied upon herein and decided both by the Supreme Court and this court—nevertheless states a similar rule for review in district court actions under the Administrative Procedure Act, 5 U.S.C. § 706 (1970). The APA, of course, does not govern jurisdiction in the Court of Claims. *McGrath* v. *United States*, 207 Ct. Cl. 978 (1975).

(1966); *Knotts* v. *United States*, 128 Ct. Cl. 489, 121 F. Supp. 630 (1954).

As shown by all the foregoing authorities, and by many others which could be cited—for our experience with adverse actions in personnel cases is considerable—we have consistently interpreted determinations of what will promote the efficiency of the service under the Lloyd-LaFollette Act and the Veterans' Preference Act (note 2) as discretionary with the employing agency officials and the Civil Service Commission. As stated above, the proper and historic scope of our consideration is to test whether such determinations are in good faith and supported by substantial evidence, or whether void because arbitrary, capricious, malicious or in bad faith, in excess of legal authority or in violation of statutes and regulations. Plaintiff must overcome the presumption of good faith on the part of the administrative officers. It requires almost irrefragable proof to demonstrate abuse of discretion sufficient to overcome the presumption. It is not even necessary that the court find that the agency construction is the only reasonable one or that it is the result the court would have reached had the question been permitted to arise in the first instance in judicial proceedings. It is enough if the decision has a rational basis by the standards enunciated and in the case law relied on here. Accordingly, we do not decide whether this legally faultless killing amounts to such cause for removal as will promote the efficiency of the service. That is not our function.

II

Thus, having charted the appropriate bounds of our review by reference to time-honored guidelines, we turn to the questions for decision. We are first required to decide whether plaintiff's *removal* from the service on the basis of the charge and specification against him was in good faith or was arbitrary, capricious, or unsupported by substantial evidence.[7]

It will be recalled that the specification embodied in the letter of proposed removal delivered to plaintiff alleged that

[7] Plaintiff has not relied on violation of statutes or applicable procedural regulations.

on May 9, 1965, he "brought discredit on the Internal Revenue Service by fatally shooting Miss Winifred O. McLaughlin." In order to overturn the adverse adjudication, plaintiff might therefore demonstrate that the agency did not possess substantial evidence to support either or both of two findings: (1) that plaintiff fatally shot Miss McLaughlin, or (2) that plaintiff brought discredit upon the Internal Revenue Service.

At the time plaintiff was first notified of his removal, June 4, 1965, the evidence consisted of newspaper accounts and the investigative report. The agency must have considered such evidence, at least in part for the truth of the matter asserted therein, namely, that plaintiff fatally shot Miss McLaughlin. To this extent the evidence was entirely hearsay in the classic sense. Fed. R. Evidence 801(c). It cannot be denied, however, that hearsay can be substantial evidence to support an administrative adjudication. *McKee* v. *United States*, 205 Ct. Cl. 303, 500 F. 2d 525 (1974); *Jacobowitz* v. *United States*, 191 Ct. Cl. 444, 424 F. 2d 555 (1970); *Peters* v. *United States*, 187 Ct. Cl. 63, 70–71, 408 F. 2d 719, 722–23 (1969). The Supreme Court has approved this rule. *Richardson* v. *Perales*, 402 U.S. 389, 401–02 (1971).

The IRS was, therefore, confronted with the hearsay recitals of area newspapers and the investigative report of plaintiff's arrest. In view of the number of newspapers which carried the story we think that insofar as they reported the fact of a shooting, resulting in death observed by witnesses, they provided reliable and substantial evidence. The arrest itself, although as noted it did not form the basis of the removal action, provided further evidence of the fact of homicide. There was substantial, corroborated evidence, albeit hearsay, as of June 4, 1965, to support the conclusion of a reasonable mind and the administrative finding that plaintiff in fact shot his mistress to death. He did not then and does not now deny that the shooting took place.

We next inquire whether the evidence of record on June 4, 1965, was substantial evidence to support a finding that the shooting brought discredit on the Internal Revenue Service. We think it was. To this extent the newspaper articles were not hearsay, since the truth of their content has no bearing

on the question of whether the agency was discredited. The mere existence of such accounts, including as they did pictures of plaintiff and his victim and headlines emphasizing his employment with IRS, was substantial evidence from which the agency, and ultimately the Civil Service Commission, were entitled in their discretion to conclude that plaintiff's conduct brought discredit upon his employer. Therefore, on both issues—the fact of the shooting and consequent discredit to IRS—the record exhibits substantial evidence. Reasonable minds could accept such evidence as adequate to support the stated conclusions at the time they were made. *Consolidated Edison Co.* v. *NLRB*, 305 U.S. 197, 229 (1938); *Jacobowitz* v. *United States*, *supra*, 191 Ct. Cl. at 456, 424 F. 2d at 561.

The only other allegation of error germane to the removal which merits discussion is the implicit assertion that IRS acted arbitrarily, capriciously, or in a manner abusive of its discretion in peremptorily effecting plaintiff's removal before his indictment or trial in the Maryland courts. We have approved the administrative practice of deferring post-suspension action on proposed final removal from federal employment until the conclusion of criminal proceedings, particularly where the allegations giving rise to the prosecution also constitute the specifications in the adverse personnel action. *Peden* v. *United States*, 206 Ct. Cl. 329, 512 F. 2d 1099 (1975); *Cohen* v. *United States*, 177 Ct. Cl. 599, 369 F. 2d 976 (1966), *cert. denied*, 387 U.S. 917 (1967). But, we have never been of the opinion that such a course must invariably be followed in the good faith exercise of sound discretion or that our scope of review could require it. Where authorized officials find themselves possessed of substantial evidence tending to prove both the fatal shooting of another by an employee and consequent immediate discredit to the service through publicity of such conduct, all tending to impair public confidence in violation of the agency's Rules of Conduct (see note 3), without prejudice to other proper procedures, it is entirely permissible in the agency's discretion to effect prompt removal based upon such then-available substantial evidence of record. In *Holman* v. *United States*, *supra*, plaintiff was removed from his position in 1963 for an alleged immoral act

for which he was acquitted in a criminal court in 1966. The court said that the acquittal did not require the conclusion that his separation from Government service was arbitrary. Plaintiff was also removed before acquittal in *Prater* v. *United States*, 172 Ct. Cl. 608 (1965), *Croghan* v. *United States*, *supra*, and in other cases. Compare the quote supporting expeditious action in *Arnett* v. *Kennedy*, note 6. Such action, of course, is subject always to the corresponding privilege of the aggrieved former employee to apply for reinstatement and to exhaust such rights of administrative appeal as are afforded by applicable statutes and regulations.[8] A similar procedure was followed in plaintiff's case. On final discretionary consideration by the Civil Service Commissioners, his case was reopened and remanded to the Appeals Examining Office for adjudication on the merits. In the circumstances, we are not prepared to say that the record shows excessively precipitous action which is arbitrary, capricious, or an abuse of agency discretion requiring our disapproval.[9]

Plaintiff, however, asserts that public image considerations are not a sufficient basis for discharging an employee who is without fault. But, fault may be in the eye of the beholder. The federal employee is on notice that he must maintain a good public image. Plaintiff was on notice of his agency's rules which provided for adverse action against an employee whose conduct might subject the agency to public criticism for keeping on the payroll a person under suspicion of murder or any other crime. IRS was especially sensitive

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[8] The propriety of this approach is confirmed by Section 14 of the Veterans Preference Act of 1944, now codified at 5 U.S.C. § 7512(b)(1) (1970):

"(b) A preference eligible employee against whom adverse action is proposed is entitled to—

"(1) at least 30 days' advance written notice, *except when there is reasonable cause to believe him guilty of a crime for which a sentence of imprisonment can be imposed*, stating any and all reasons, specifically and in detail, for the proposed action; * * *." [Emphasis supplied.]

See also 5 C.F.R. § 752.202(c)(2) (1975) to the same effect.

[9] Even if we entertained the view that the swiftness of the removal was error, which of course we do not, such error would be harmless. To sustain a recovery based upon administrative impropriety a plaintiff must demonstrate the manner in which he has been prejudiced thereby. *Hart* v. *United States*, 204 Ct. Cl. 925, 498 F. 2d 1405, *cert. denied*, 419 U.S. 1049 (1974); *Haynes* v. *United States*, 190 Ct. Cl. 9, 418 F. 2d 1380 (1969); *Cohen* v. *United States*, 177 Ct. Cl. 599, 369 F. 2d 976 (1966), *cert. denied*, 387 U.S. 917 (1967). Plaintiff lost no additional salary because of removal, for he had already been suspended without pay. Moreover, plaintiff did ultimately secure review on the merits before the Civil Service Commission.

because of its need to maintain public confidence in its image of integrity, depending as it does essentially on voluntary compliance of the public. *Hoover* v. *United States*, 206 Ct. Cl. 640, 513 F. 2d 603 (1975); *Birnholz* v. *United States*, 199 Ct. Cl. 532, 537 (1972). It was the thrust of the testimony of plaintiff's supervisor that any scandal involving an IRS employee impaired the integrity of the office. Like Caesar's wife, IRS employees are supposed to be above suspicion. In its discretion that agency is entitled to act with promptness in maintaining the efficiency of the service by such disciplinary actions as will maintain public confidence. This concept is explicit in the Foreword (by the Commissioner of Internal Revenue) to the Rules of Conduct for Internal Revenue Service Employees (Rev. 10–63), which states in part:

> * * * We can maintain public confidence only to the extent that every one of our contacts with the public reflects the highest ethical and moral standards.
>
> In addition to our daily assigned tasks, each of us has an important public relations role to play. Not only must we act with complete propriety, but we must be sure that none of our actions can be interpreted otherwise. * * *.

Section 1941.4 of the Rules has heretofore been quoted in footnote 3 and was included in the charge against plaintiff by his agency. It, too, emphasizes the importance of maintaining public confidence in the agency through conduct which will bring credit, not discredit, upon the Internal Revenue Service, with removal from employment a possible sanction for failure to behave both outside and during working hours in a manner above reproach. Additionally, 5 C.F.R. § 735.209 (1975) provides:

> An employee shall not engage in criminal, infamous, dishonest, immoral, or notoriously disgraceful conduct, or other conduct prejudicial to the Government.

Surely plaintiff's conduct, however legally faultless, could in the agency's discretion be found to have run afoul of these admonitions against bad public relations and notoriously disgraceful conduct prejudicial to the Government and falling short of the highest moral standards. It would be a curious thing indeed if just because a state's attorney declined

to prosecute a homicide the IRS would be deprived of its right and duty to enforce its own published rules and regulations for employee conduct. It would be more curious still if, indulging in the luxury of hindsight and speculation, this court should enforce such a result by concluding that had the IRS known that the state's attorney would not press the indictment and that the court would acquit plaintiff on insanity grounds, that the IRS would not have enforced its rules which implicitly mandate speedy action to accomplish their plainly stated purposes which are altogether unrelated to the merits of a criminal charge or defense thereto. *Croghan* v. *United States*, *supra*, 116 Ct. Cl. at 586, 89 F. Supp. at 1004. Further, to argue that the better practice would have been for IRS to have withheld action on the removal until the criminal case was concluded does not give the court authority to so require it in the face of rules, regulations, and statutes which seem to contemplate otherwise and where the agency's discretion is not shown to have been abused or based on insubstantial evidence in applying those restrictions.

III

Next we consider whether the refusal of IRS to reinstate plaintiff upon his return and after acquittal by reason of insanity is legally wanting. Once again we do not decide the merits of the agency's decision to decline reemployment. In cases such as this whether plaintiff should be employed by the Government is no concern of the judicial department.

Our attention has been directed to FEDERAL PERSONNEL MANUAL, Chapter 306, Subchapter 5–2 (1969), where it is said:

> As a general rule, a history of mental illness is not disqualifying for Federal employment provided that recovery has been certified by competent medical authority and the applicants are capable of performing the duties of the position without hazard to themselves or others * * *.

Thus, prior mental illness bars neither initial employment with the Government nor reinstatement, so long as the impediment to health has been removed. That is not to say by

any means, however, that a victim of prior mental illness *must* be restored to duty. We have held time and again that acquittal of a criminal charge does not erect a bar to adverse action in respect of one's federal employment. *Holman* v. *United States*, *supra*; *Prater* v. *United States*, *supra*; *Finn* v. *United States*, *supra*; *Bryant* v. *United States*, 122 Ct. Cl. 460 (1952), *cert. denied*, 344 U.S. 913 (1953); *Croghan* v. *United States*, *supra*. By analogy, acquittal of a criminal charge based upon a plea of legal insanity does not bar the employing agency from denying reinstatement, where such denial violates no statute or regulation and is neither arbitrary, capricious, nor an abuse of discretion.[10]

On the record before us we cannot say that the agency erroneously rejected plaintiff's bid for his former job. Having initially removed him in a legally proper manner in view of what it in good faith judged to be such cause as would promote the efficiency of the service, the agency acted within permissible limits in requiring plaintiff to pursue the matter of his removal before the Civil Service Commission. IRS apparently took the position that if in view of new evidence the removal fell, so too would its decision not to reinstate. We are unable to perceive the slightest impropriety in such a procedure. On the contrary—we think it to have been eminently fair. The extensive administrative record has been supplemented by a 3-day trial in court, by detailed findings, and close attention by the trial judge and this appellate panel to the procedures followed in plaintiff's removal.

IV

Plaintiff's removal from office was based upon substantial evidence and was neither arbitrary nor capricious. We find no legal fault with the decision of IRS and CSC not to re-

[10] *See* 5 U.S.C. § 3315 (1970):

"(a) A preference eligible who has been separated or furloughed without delinquency or misconduct, on request, is entitled to have his name placed on appropriate registers and employment lists for every position for which his qualifications have been established, * * *.

"(b) The Commission *may* declare a preference eligible who has been separated or furloughed without pay under section 7512 of this title to be entitled to the benefits of subsection (a) of this section." [Emphasis supplied.]

instate him. Accordingly, the plaintiff is not entitled to recover.

The core of plaintiff's case is his belief that it is unjust to deprive a man of his job who was not responsible for the act giving rise to the removal and that there is no nexus between his offense and removal. In keeping with settled principles of law we have declined to base this opinion on the debatable question of whether this killing, faultless in legal contemplation, may be deemed such cause for removal as promotes the efficiency of the service. "It is not within the jurisdiction of the court to inquire into the guilt or innocence of the plaintiff as to the charges upon which he was removed from office." *Golding* v. *United States*, 78 Ct. Cl. 682, 685, *cert. denied*, 292 U.S. 643 (1934). The wisdom of such a long-standing judicial position is evident, although on the facts of this case it would not be difficult to reach such a tempting conclusion. But, to assume jurisdiction to second-guess the administrators on what is best for efficiency of the service treads on dangerous ground. Such perplexing questions are better resolved at the administrative level, according to the tenor of our prior decisions respecting the separation of powers. It is the unquestioned right of the executive to select employees in that department. Further, as held by the Supreme Court in an opinion by Mr. Chief Justice Taft in the landmark case of *Myers* v. *United States*, 272 U.S. 52 (1926), the power of removal is incident to the power of appointment. *See also Burnap* v. *United States*, 252 U.S. 512 (1920); *Keim* v. *United States*, 177 U.S. 290 (1900); *Radford* v. *United States*, 264 F. 2d 709, 710 (5th Cir. 1959); *Morelli* v. *United States*, 177 Ct. Cl. 848, 858 (1966). The appropriate penalty to impose upon an employee for infraction of an agency's rules is within the discretion of the agency subject to review on the merits by the Civil Service Commission, as in this case, and subject to judicial review on a more limited basis for procedural regularity and abuse of administrative discretion and bad faith. *Hoover* v. *United States*, *supra; Grover* v. *United States*, 200 Ct. Cl. 337, 353 (1973); *Liotta* v. *United States*, 174 Ct. Cl. 91, 96 (1966); *De Nigris* v. *United States*, 169 Ct. Cl. 619, 625 (1965). We decline the invitation in this case to abandon

long-established precedents and make bad law. The petition must be dismissed.

It is so ordered.

LARAMORE, *Senior Judge*, dissenting:

The facts of this case are concededly grotesque. As the majority views the unhappy events:

> On Mother's Day, Sunday, May 9, 1965, * * * plaintiff and Miss McLaughlin set out by car * * *. [F]or unknown reasons an altercation took place between them. They left the car, whereupon plaintiff seized a 4-barreled Derringer and killed her with two shots as she sought to flee * * *.

Plaintiff, a veterans' preference eligible, was at this time employed by the Internal Revenue Service. Charged with murder, he was found by a Maryland state court to have been not guilty by reason of insanity. Since that time, however, a jury in a later proceeding found that plaintiff had regained his sanity. He now seeks reinstatement to his former position with back pay.

The majority goes to great pains to demonstrate that this is a case easily decided. But my brothers rely upon the emotional appeal of the facts and a conception of judicial review of administrative action—which, in my judgment, no longer prevails—to cloak this court's responsibility to dispassionately resolve the issues.

While in this case a potentially unpopular result renders this responsibility onerous, I must accept the burden and respectfully dissent.

I

Primarily, I cannot accept the standard of review which is being adopted today in the opinion of the majority. At one point my brothers quote part of a paragraph from *Schlegel* v. *United States*, 189 Ct. Cl. 30, 40, 416 F. 2d 1372, 1378 (1969), *cert. denied*, 397 U.S. 1039 (1970), for the proposition that this court has *no* role to play in determining whether or not there is a sufficient nexus between the removal action under review and the efficiency of the service. Recitation of the full passage is necessary to demonstrate their mis-

Dissenting Opinion by Judge Laramore

taken reliance on the language quoted out of context (emphasis supplied to the portion omitted by the majority):

> Whether a person's discharge will promote the efficiency of the service is an administrative decision to be determined within the discretion of the agency, and no court has power to review the action, if taken in good faith. *Brownell* v. *United States*, 164 Ct. Cl. 406, 408–409 (1964); *Gadsden* v. *United States*, 111 Ct. Cl. 487, 489, 78 F. Supp. 126 (1948). *At the trial of the instant case before Commissioner Stone, three of plaintiff's superiors offered testimony indicating that the morale and efficiency of the office would have been affected by plaintiff's continued presence. This testimony, when coupled with the administrative determinations concerning efficiency of the service, constitutes convincing proof that plaintiff's removal promoted the efficiency of the service and eliminated plaintiff's detrimental influence on the efficiency of the service.*

Several observations concerning *Schlegel* are in order. First, as the emphasized language cited above makes clear, this court affirmatively agreed with the determination of the Civil Service Commission and blind reliance upon agency expertise was not utilized in that case. Before affirming the agency's decision, we satisfied ourselves that the removal promoted the efficiency of the service. Second, *Schlegel* expressly distinguished the facts of *Norton* v. *Macy*, 417 F. 2d 1161 (D.C. Cir. 1969). My reading of *Schlegel* leaves me perplexed as to the basis for the implicit conclusion by the court in the instant case that *Schlegel* disapproved the standard of review used in *Norton*. To the extent any disagreement may have been expressed in *Schlegel*, it concerned the substantive merits of the disputed discharge, rather than the standard of review. *Schlegel*, *supra*, 189 Ct. Cl. at 40–41, 416 F. 2d at 1378.

It is true that at one time the prevailing view was to rely exclusively upon the expertise of administrative agencies for correct application of specialized statutes. *See*, *e.g.*, *Gray* v. *Powell*, 314 U.S. 402 (1941). However, the advent of the Administrative Procedures Act[1] in 1946 precipitated an

[1] Act of June 11, 1946, 60 Stat. 237, as amended, 5 U.S.C. §§ 551, *et seq.*, and 701, *et seq.*

eventual shift in emphasis so that courts now have a responsibility to review even discretionary administrative action. *Citizens to Preserve Overton Park* v. *Volpe*, 401 U.S. 402 (1971); *Ciambelli* v. *United States*, 198 Ct. Cl. 240 (1972). Acknowledging this, the majority, in this case, adopts "good faith" as its standard of review. And at certain points in its opinion the court appears to define a "good faith determination" in a manner which would preclude arbitrary and capricious action, a determination unsupported by substantial evidence or an action contrary to law. Yet, my brothers allude to those terms without any real attempt to apply their meaning. While the scope of review under these standards may indeed be narrow, this court has an important responsibility to determine whether a particular case falls within the narrow category of cases where it must determine that legal error has been committed.

The Supreme Court of the United States in *Bowman Transportation, Inc.* v. *Arkansas-Best Freight System, Inc.*, 419 U.S. 281, 285 (1974), has recently laid down the rule that, as a reviewing court, we must determine the legal framework within which administrative discretion is exercised:

> Under the "arbitrary and capricious" standard the scope of review is a narrow one. A reviewing court must "*consider whether the decision was based on a consideration of the relevant factors* and whether there has been a clear error of judgment * * *. Although this *inquiry into the facts is to be searching and careful*, the ultimate standard of review is a narrow one. The court is not empowered to substitute its judgment for that of the agency." *Citizens to Preserve Overton Park* v. *Volpe*, *supra* at 416. *The agency must articulate a "rational connection between the facts found and the choice made. Burlington Truck Lines* v. *United States*, 371 U.S. 156, 168 (1962) * * *. [Emphasis supplied.]

Bowman states what I believe in this case to be the proper scope of our responsibility of review.

II

I consider now the action taken by the agency which is at issue and additional reasons which compel me to voice my disapproval of the court's review. The court devotes substantially all of its discussion to the removal action by the In-

ternal Revenue Service (IRS) on June 4, 1965, and the evidence adduced by the IRS at that time. Only one meager statement in the majority's opinion reveals that plaintiff's case was, in fact, reopened by the Civil Service Commission and remanded to their Appeals Examining Office (AEO) for a *new adjudication on the merits.* The reopening of the case for a decision on the merits, in my view, spares this court the necessity of having to decide whether the removal action taken by the IRS was improper. Instead, the action I would regard as coming under review is the notice of April 4, 1968, by the Chief of the AEO (affirmed by the full Board, by letter, on June 28, 1968), in which the plaintiff's removal was sustained.

Since the Civil Service Commission's decision of April 4 should have been the agency action primarily reviewed by this court, this court's review should have taken into account all of the evidence available to the Civil Service Commission at the time of his final action, and not merely the evidence adduced at the time of removal by the IRS. Moreover, in considering the issue of arbitrariness, the court may review all available evidence, including *de novo* evidence taken before one of our trial judges, as well as the administrative record. *Schlegel* v. *United States*, *supra; Brown* v. *United States*, 184 Ct. Cl. 501, 396 F. 2d 989 (1968).

It is beyond question that there has been at least a minimal showing, upon the record, that plaintiff's mental condition was impaired at the time he committed the act for which he was removed. The decision of the AEO on April 4 impliedly refers to this in stating that plaintiff's conduct was inconsistent with the proper standard of conduct for employees "regardless of their state of mind." Thus, plaintiff's state of mind was a factor taken into account by the AEO in passing upon the legal merits of plaintiff's discharge. In light of this, the decision of the AEO enunciates what, in my view, is an erroneous construction of the laws applicable to the facts of this case.

With respect to the legal merits, the April 4 decision stated, in pertinent part:

> * * * The fact of the matter is that an Internal Revenue Agent has killed a human being, and has only escaped punishment by virtue of a plea of insanity. *It is a simple*

conclusion of fact that the unjustified killing of a human being is inconsistent with the standard of conduct for employees in the Federal Service regardless of the state of their mind at the time the killing was committed. Therefore, we find the appellant's removal was for a cause which promoted the efficiency of the service. [Emphasis supplied.]

And yet, both the IRS and the Civil Service Commission accept the view that mental illness is not a cause for removal or denial of reinstatement if the employee has recovered. The Civil Service Commission policy, set forth in Federal Personnel Manual, chapter 306, 5–2 (1969), is that, "as a general rule, a history of mental illness is not disqualifying for Federal employment provided that recovery has been certified by competent medical authority and the applicants are capable of performing the duties of the position without hazard to themselves or others * * *." Thus, subchapter 5–2 provides for initial employment and for reinstatement if the employee has previously been dismissed for reasons attributable to mental illness. *See Manzi* v. *United States*, 198 Ct. Cl. 489, 493–494 (1972). I think it odd that while cured mental illness is not disqualifying for Federal employment that an employee could still be subject to a disciplinary dismissal for conduct resulting from such an illness.[2]

Plaintiff is entitled to the benefits of the Veterans' Preference Act of 1944, 5 U.S.C. §§ 3315, 7512, 7701, which was designed to confer a measure of additional job security on veterans not enjoyed by unprotected Federal employees. Insofar as Congress provided therein that an employee having such status may be dismissed "only for such cause as will promote the efficiency of the service," it plainly meant that "the employer agency must demonstrate some 'rational basis' for its conclusion that a discharge 'will promote the efficiency of the service.'" *Norton* v. *Macy*, *supra* at 1164. I believe it is not reasonable nor rational to construe the Rules of Conduct of IRS Employees to threaten sanctions for anything less than volitional or conscious behavior because there is no real deterrent purpose that can be served in a disciplinary

[2] There is no doubt that the charge upon which plaintiff's dismissal was based was a disciplinary one because it was based purely on plaintiff's past conduct and not his inability to perform in the future.

removal when all the evidence points to lack of moral culpability. *Cf. Morissette* v. *United States*, 342 U.S. 246 (1952). The Civil Service Commission's action in this case thus smacks of emotionalism rather than reasoned decision making.

Moreover, I do not believe, as the majority implies, that in enacting the Veterans' Preference Act of 1944, Congress intended to permit an agency to achieve the purpose of acquiring or maintaining a good public image at the price of dismissing veterans as disciplinary measures for conduct for which they may have been wholly without legal fault. I cannot, in good conscience, join the court today in holding that "fault may be in the eye of the beholder," for to do so would be taking away a good measure of the job protection that Congress sought to provide for veterans who have honorably served the country in and out of military uniform.

In summary, my view is that the Commission was under a clear legal misapprehension when it refused to consider the plaintiff's state of mind as bearing upon his legal and moral culpability. However, there is no need to remand this case to the Civil Service Commission because no exceptions were taken by either party to the factual findings of Trial Judge Miller, and the case is now one purely of applying the law to the findings. Two pivotal findings read as follows:

> 41. On May 8, 1965, at the time when plaintiff killed Miss Winifred O. McLaughlin, plaintiff was of such mental incapacity and reason so as not to be able to properly distinguish between right and wrong, nor to know the nature and consequences of his acts as applied to himself, and was not responsible for his actions.
>
> 42. On April 6, 1966, when plaintiff applied to IRS for reinstatement to the position from which he had been removed, and at all relevant times thereafter plaintiff was recovered from his mental illness, was of sound mind, did not represent a threat to the safety or property of others, and was fully able to perform the duties of such position.

On this basis, I would find that the Civil Service Commission could not properly find that legal "cause" existed for

plaintiff's removal for violating the Rules of Conduct of IRS Employees.[3]

However, with respect to the question of reinstatement, I concur with the majority because, under the jurisdictional act of this court, restoration is discretionary.

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527 F. 2d 1207

ON PLAINTIFF'S MOTION FOR REHEARING EN BANC AND MOTION TO RECONSIDER JUDGMENT

January 30, 1976

ORDER

This case comes before the court on plaintiff's motion, filed January 5, 1976, for rehearing *en banc* and motion for rehearing to reconsider judgment pursuant to Rules 7(d) and 151(b). Upon consideration thereof, together with the response in opposition thereto, without oral argument, by the seven active judges of the court as to the suggestion for rehearing *en banc* under Rule 7(d), which suggestion is denied*, and further having been so considered by the panel listed above as to the motion for rehearing under Rule 151(b),

IT IS ORDERED that plaintiff's said motion for rehearing be and the same is denied**.

NICHOLS, *Judge*, concurs in the result as follows:

Since I do not agree with statements in the majority opinion, yet have decided to vote against rehearing because I do agree with the result, I respectfully submit this statement of my views.

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[3] This proceeding involves questions of exceptional importance and difficulty, and since the opinion of the court, in my judgment, seems to depart from prior decisions with respect to the question of our scope of review, this case appears to be an appropriate candidate for rehearing en banc pursuant to Rule 7 (b) or (d).

*DAVIS, *Judge*, dissents in that he would allow plaintiff's suggestion for rehearing *en banc* under Rule 7(d).

**LARAMORE, *Senior Judge*, dissents in that he would allow plaintiff's motion for rehearing to reconsider judgment under Rule 151(b).

Concurring Opinion by Judge Nichols

The Maryland court proceedings dealing with Mr. Wathen, as reported in the majority opinion, seem at first blush to furnish a prime example of the reasons why people are losing faith in our system of criminal justice, and must eventually subject it to sweeping reforms. However, the careful opinion and findings of Trial Judge Philip R. Miller, afford no basis to impugn the good faith of anyone concerned, or the legal correctness of the Maryland judicial rulings, or the professional competence of the psychiatrists who achieved, according to themselves, such an apparently miraculous cure. If defendant had offered evidence on these points we might have had a different case. There are limits to res *judicata* and collateral estoppel in cases, *e.g.*, of fraud on the court, but such issues do not confront us here. Though we are a society that recoils in horror against taking of life by the state, we treat such taking by anyone else as a very minor peccadillo. The fact remains plaintiff has blood on his hands, and all the absolution the psychiatrists can offer will not suffice to wash it off.

The panel attacks its case the hard way by raising the vexed, but here I think moot, issue as to whether, or to what extent, an administrative decision that a removal will promote the efficiency of the service, is subject to judicial review. At one time I took issue with *Norton* v. *Macy*, 417 F. 2d 1161 (D.C. Cir. 1969), which innovated such review, believing it to be a judicial intrusion into an area reserved for executive discretion when it is a matter, at least, of deciding what kinds of behavior are detrimental to service interests. I am gratified to see others coming to my opinion, but I am no longer so sure of it myself. It is anomalous to have a single separate area of decision making excluded from judicial review when such exclusion is not based on express statutory provisions, absent here. When Congress desires to preclude judicial review it knows how to do it. *Chambers* v. *United States*, 196 Ct. Cl. 186, 451 F. 2d 1045 (1971). However judges must be careful not to presume automatically that their wisdom is superior. Running executive agencies is difficult enough even for those appointed to do so and in daily contact with the problems. Identification of service interests and weighing priorities with respect thereto are

matters of high executive discretion. Where *Norton* v. *Macy* went wrong was in giving insufficient respect to the agency's ideas as to what was needed to maintain its efficiency, not in venturing on forbidden territory. Yet, particularly in the area of alleged off-duty misconduct, there can easily be, and in the past, have been, abuses of executive discretion in unreasonable efforts to regulate the off-duty behavior of Government employees.

In *Schlegel v. United States*, 189 Ct. Cl. 30, 416 F. 2d 1372 (1969), *cert. denied*, 397 U.S. 1039 (1970), the court majority seemed to me to have it both ways, reviewing favorably the administrative determination of what was good for the service, while asserting it was immune from such review. It attempted to distinguish *Norton v. Macy* on the facts instead of disapproving it as I would have done. The panel majority here may be right as to the almost irrefragable proof required to overturn the executive decision, if you limit it to on-duty misconduct, yet be wrong as to off-duty misconduct.

The issue is moot, for me, in Wathen's case, because it is for me too plain for argument that it is not good for the Internal Revenue Service's efficiency to employ an agent with Mr. Wathen's history, *i.e.*, one who has taken life — even if only once — in a fit of dissociation when faced with apparently insurmountable stress and emotional trauma, has avoided (in the lawyer's dichotomy, I do not say evaded) the law's penalty for murder on the ground of insanity, and has won release shortly thereafter on the ground of being perfectly sane. Such people have their qualities, and there must be a niche for them somewhere, but surely not in the IRS! I cannot help asking how a taxpayer would like having Mr. Wathen call on him to audit his tax returns. Would he eye him for a suspicious bulge, or ask him to undergo a pat-down search? The dissent in this case is not written out of perfect faith in the psychiatrist's one in ten thousand estimate of the chances of a relapse, at the dissent's caveat against ordering reinstatement shows. But if Wathen should not be reinstated in 1976, how can the agency be faulted for not doing so in 1966?

The real question is whether the offense violated any regulation of the IRS. "Conduct to discredit" is a concept derived

from military law. We know from *Parker v. Levy*, 417 U.S. 733 (1974), that it adequately describes a host of off-duty offenses. Testimony that the behavior actually lowered public esteem for the agency, or did not, should not be required in every case. We know by the Maryland court decisions that Wathen was not guilty of murder. Our trial judge analizes the holdings as indicating a lack of *mens rea* because of Wathen's temporary psychiatric condition, and he would read a *mens rea* requirement into the IRS regulation too. It is not correct to say that Wathen was exonerated of all legal fault. I do not think *mens rea* is required for a civil action for wrongful death. The Maryland courts did not have this issue before them. One could well suppose, and I do suppose, that Wathen may be or have been liable to the heirs or next of kin of his victim, Miss McLaughlin. The way the agency testified, and the way it framed its charges, it is clear it considered that homicide without *mens rea* was conduct to discredit. They would not properly apply it, of course, to a purely accidental homicide, free of all fault, but that is not this case, nor is a homicide in self-defense. It seems to me a perfectly rational application of the prohibition against conduct to discredit, to apply it to all homicides except those where the employee is or should be exonerated of legal fault, noting the difference between being without fault and without *mens rea*. In this case, so far as we know, he has never been exonerated of anything except the charge of murder, and he was exonerated of that on grounds, lack of *mens rea*, that would have no impact on civil liability.

By my analysis, therefore, the plaintiff is not aided by his acquittal and it may be moot whether the agency's case should be evaluated as it was when the plaintiff was dismissed, or as of the final stage of administrative review, as the dissent urges. As to this, if we must decide it, I agree with the dissent. We held in *Peden* v. *United States*, 206 Ct Cl 329, 512 F. 2d 1099 (1975) that the agency could use as part of its "substantial evidence" at the hearing, newly discovered or newly available incriminating testimony the agency did not have when it terminated the plaintiff's employment. It would seem to follow he should have a right to use new evidence or

new developments that favored his case, until administrative finality is reached and perhaps even after.

The agency that has a choice of misconduct charges, or involuntary retirement for psychiatric disability, nearly always opts for the former, and with good reason. A proposal along the latter line precipitates an embittered and costly struggle, which should be avoided when possible, in the interests of both sides. Most people can live easier with the idea they have committed misconduct than that they are psychiatrically disabled, even when, in a pecuniary sense, the latter option would be preferable for them. Nor do they care to have their psyches examined by Government psychiatrists, not of their own choice. For this reason it appears to me that agency codes of conduct, and tables of penalties for misconduct, should generally be read as applicable to the prohibited conduct whether or not committed with *mens rea* The concept of *mens rea* should be confined to the criminal law, where it originated and where it belongs. Agencies confronted with irrational and self-defeating behavior on the job should not be judicially required to consider *sua sponte* whether it is due to psychiatric disability If the offending employee sets up psychiatric disability and offers to accept disability retirement in lieu of discharge, he should receive every consideration, and so far as I am aware, he usually does.

It seems to me that the very idea of disability in the Civil Service context, means inability to meet the physical or psychic requirements of the particular job, whatever they are. Should the agency have determined that plaintiff's history made him unsuitable for re-employment, it could not consistently have refused him a disability retirement, in my judgment. This conclusion obtains even if the agency determined that plaintiff committed the offense stated in the charging letter, since the offense, as stated by it, was committed whether or not plaintiff was psychiatrically disabled. In short, the disability retirement, with annuity, appears to me to be the solution the Civil Service laws prescribe for instances where the employee has violated an agency regulation, but excusably because of his psychiatric condition. The extreme remedy of forcing him back to active duty is one the courts should shun whenever possible, as it assuredly will not

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make for the efficiency of the service. This is not to say that in this case, at this time, a disability retirement is still a possible solution.

Among the members of our own bench, and I expect with others, the outcome one way or the other is seemingly viewed as morally wrong and leading to obnoxious consequences. The case is a polarizing one. My object in writing has been to point out that, even given the bizarre circumstances of this case, extreme positions were not, antecedently considered, necessary, and a reasonable intermediate solution was, antecedently considered, possible under existing law.

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534 F. 2d 232

CHARLES J. PETERS v. THE UNITED STATES

[No. 470–73. Decided December 17, 1975. Plaintiff's motion for rehearing and disqualification denied January 30, 1976]

ON PLAINTIFF'S AND DEFENDANT'S MOTIONS FOR SUMMARY JUDGMENT

Civilian pay; detail but non-appointment to higher position; failure to exhaust administrative remedies; CSC non-processing of agency recommendation; super-grade positions.—Plaintiff, a now-retired GS–16 Associate General Counsel of the Federal Aviation Administration (FAA), seeks the additional pay and retirement benefits of the GS–17 post of Deputy General Counsel to which he was detailed on January 8, 1968, and in which he served until February 22, 1971. Plaintiff was paid at his GS–16 rate since he was only "acting." In September 1968 the Acting FAA Administrator approved a recommendation that plaintiff be promoted to the said GS–17 post; the Office of the Secretary of Transportation, Executive Personnel Board concurred; pursuant to 5 U.S.C. § 3324 a request for approval of the recommendation was sent to CSC on December 27, 1968; and on January 22, 1969 CSC returned a list of high-level personnel proposals, including plaintiff's, to the Department of Transportation, commenting "rather than proceeding with the processing of these cases, we are sending them back to you to ascertain whether the proposed actions are in keeping with the Department's program needs and priorities at this time." This was during the period of a national election campaign and a change in administration. Plaintiff never asserted his claim administratively. Plaintiff contends that the CSC acted illegally, arbitrarily and capriciously in failing to process the FAA recommendation for appointment, and also alleges violation of 5 U.S.C. § 3341(a) in being detailed overly long in the

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"acting" capacity. It is *held* that plaintiff was never officially appointed to the GS–17 post, no special statute or regulation gives him entitlement to the post, and accordingly he is not entitled to the higher salary. It is also *held* that since plaintiff never instituted grievance proceedings but chose to remain in the detail and accepted the benefits, he is estopped to attack the detail. It is further *held* that CSC was in no way arbitrary or capricious in returning without processing plaintiff's appointment papers, together with others, to the Department for appropriate resubmission after a change in administration. Plaintiff's motion for summary judgment is denied, defendant's cross-motion is granted, and the petition is dismissed.

Civilian pay; appointment and tenure; generally.

[1] A Government employee is entitled only to the rights and salary of the position to which he has been appointed. Thus, an employee serving in a higher position to which he has not been appointed is not entitled to the pay of said higher position absent a statute or regulation providing therefor.

United States ⇐ 39(2)

Civilian pay; promotions; Court of Claims jurisdiction; generally.

[2] Where the employing agency has failed to promote an employee, for the court to promote there must be a clear legal entitlement to such promotion.

United States ⇐ 36

Civilian pay; administrative remedies; failure to exhaust; generally.

[3] A Government employee must exhaust his administrative remedies before bringing suit in this court; this failure to exhaust doctrine applies to administrative appeals within an agency.

United States ⇐ 36

Estoppel; grounds for estoppel; failure to exhaust administrative remedies; benefits accepted.

[4] Where plaintiff was detailed at his same salary but never appointed to a higher position for a period in excess of 120 days as provided in 5 U.S.C. § 3341 which detail plaintiff claims constituted an unjustified and unwarranted personnel action under the Back Pay Act, 5 U.S.C. § 5596, and where plaintiff did not institute a CSC grievance proceeding but apparently chose to remain in the detailed position and to accept the benefits thereof—to the extent he retained prospects for promotion, he is now estopped to attack the detail.

Estoppel ⇐ 92(1)

Civilian pay; adverse personnel action; what constitutes.

[5] Where plaintiff was detailed but never appointed to a higher position and remained in said detail for a period in excess of the statutory 120 days but did not file a CSC grievance proceeding, since he suffered no withdrawal or reduction of pay as a result of his "acting" capacity, he was not the victim of an adverse personnel action under the Back Pay Act, 5 U.S.C. § 5596(b): he could have

pursued several alternatives but since he chose to remain in the detail he cannot now be heard to contest the legality of the detail.

United States ⇐ 39(11)

Civilian pay; appointment to higher position; failure of CSC to process agency recommendation; supergrade position.

[6] Although the employing agency approved plaintiff's appointment to the supergrade position to which he had been detailed, the Civil Service Commission's return of the request without passing on plaintiff's qualifications, occurring at a time involving a national election and possible change in administration, was not arbitrary, capricious, unreasonable or illegal, absent proof of improper motive, but rather was a sound exercise of administrative discretion in order to permit the new CSC Administrator to consider the allocation of the limited number of supergrade positions available.

United States ⇐ 36

Civilian pay; promotions; selection for promotion; agency discretion.

[7] This court will not substitute its judgment for agency discretion by ordering promotions where the agency has declined to do so.

United States ⇐ 36

Charles J. Peters, pro se.

R. W. Koskinen, with whom was *Acting Assistant Attorney General Rex E. Lee*, for defendant.

Before DAVIS, SKELTON, and KUNZIG, *Judges.*

KUNZIG, *Judge*, delivered the opinion of the court:

The basic problem in this *pro se* civilian pay case is whether the Associate General Counsel of the Federal Aviation Administration (FAA) is entitled to the higher pay and retirement benefits of Deputy General Counsel because he was not promoted to the higher post as a result of alleged arbitrary and capricious action by the Civil Service Commission (CSC). We hold the actions of the CSC *not* to have been arbitrary and capricious.

The matter comes before the court on defendant's and plaintiff's cross motions for summary judgment. The facts are not complicated and are basically non-contested.

In 1968, plaintiff was a GS–16 Associate General Counsel at the FAA. On January 8, 1968, he was designated Acting Deputy General Counsel. The post of Deputy General Counsel was then a GS–17 position, but as plaintiff was only

"acting," he was paid at his GS–16 appointment rate. On September 10, 1968, the Acting FAA Administrator approved a recommendation that plaintiff be promoted to the GS–17 position of Deputy General Counsel. The Office of the Secretary of Transportation (OST) Executive Personnel Board concurred and the "Request for Approval of Executive Selection" was sent by the Secretary of Transportation to the CSC on *December 27, 1968*, for the purpose of obtaining CSC approval of plaintiff's qualifications under 5 U.S.C. § 3324 (1970).[1]

On *January 22, 1969*, the CSC returned a list of high-level personnel proposals, including plaintiff's, to the Department of Transportation (DOT), commenting, *inter alia*, that "rather than proceeding with the processing of these cases, we are sending them back to you to ascertain whether the proposed actions are in keeping with the Department's *program needs and priorities* at this time." (emphasis added). Plaintiff served as Acting Deputy General Counsel until February 22, 1971, and finally retired on June 29, 1973. That plaintiff performed his duties in an exemplary fashion is not at issue in this case. He now claims both pay and retirement annuity accretions based on the difference between the amounts he received in his GS–16 position and that which he would have received as a GS–17.

Plaintiff has never asserted his claim administratively.

The gravemen of plaintiff's argument is that the CSC acted illegally, arbitrarily and capriciously in failing to process DOT's recommendation for his appointment as Deputy General Counsel. Plaintiff also alleges certain improprieties in being kept overly long in an "acting" capacity by FAA.

Defendant counters that CSC's action was a proper exercise of administrative discretion and that plaintiff had an obvious and clear administrative remedy against serving overly long in an acting capacity which he failed to use.

We hold for the government.

First and foremost, it is patently clear that in spite of any implication to the contrary, plaintiff was never officially ap-

[1] U.S.C. § 3324 (1970) requires CSC approval of qualifications for all appointments to GS–16, 17, or 18 supergrade positions unless the position is exempt from such approval.

pointed to the position of Deputy General Counsel.[2] Sundry proposals may have been made to promote him, but the facts are clear—no appointment was ever consummated. This court has repeatedly held that a government employee is entitled only to the rights and salary of the position to which he has been appointed. *Desmond* v. *United States*, 201 Ct. Cl. 507, 525–26 (1973); *Bielec* v. *United States*, 197 Ct. Cl. 550, 560, 456 F. 2d 690, 696 (1972); *Dianish* v. *United States*, 183 Ct. Cl. 702, 707 (1968). Thus plaintiff is not entitled to higher pay by virtue of serving in a GS–17 position to which he was never appointed.

Nor does plaintiff derive any legal entitlement to the higher pay of a GS–17 position from any specific statute or regulation. And he has cited none. For the court to order a promotion where the agency has failed to do so there must be a clear legal entitlement to such promotion.[3] *Cf. Selman* v. *United States*, 204 Ct. Cl. 675, 686, 498 F. 2d 1354, 1359 (1974); *Doggett* v. *United States*, 207 Ct. Cl. 478 (1975). If plaintiff's argument has a major defect, it is obviously here. *He was simply never entitled to the higher position.*

However, plaintiff claims his extended, overly long detail as Acting Deputy General Counsel violated 5 U.S.C. § 3341 (1970)[4] and constituted an unjustified or unwarranted personnel action under the Back Pay Act, 5 U.S.C. § 5596 (1970).[5] He now alleges it was improper for him to have been kept in an acting capacity for over 120 days. Yet he never moved administratively to bring the detail to an end. We have held that the failure to exhaust doctrine applies to administrative appeals within an agency. *Perkitney* v. *United States*,

[2] Actually, plaintiff now appears to concede that he never received the appointment. At oral argument, he no longer claimed he had received it.

[3] *See also Skrobot* v. *United States*, *post* at 475.

[4] 5 U.S.C. § 3341 (1970) provides in part:

"(a) the head of an Executive department * * * may detail employees among the bureaus and offices of his department * * *.

"(b) Details under subsection (a) of this section * * * may be for not more than 120 days. These details may be renewed by written order of the head of the department, in each particular case, for periods not exceeding 120 days."

[5] 5 U.S.C. § 5596(b) (1970) provides a remedy for:

"An employee of an agency who, on the basis of an administrative determination or a timely appeal, is found by appropriate authority under applicable law or regulation to have undergone an unjustified or unwarranted personnel action that has resulted in the withdrawal or reduction of all or a part of the pay, allowances, or differentials of the employee— * * *."

174 Ct. Cl. 79, 84–85 (1966). As Acting Deputy General Counsel, plaintiff was in as good a position as anyone to call to the FAA's attention the possible illegality of his position. Yet for over two years he was obviously satisfied to "let the matter ride." If, as plaintiff now appears to contend, the overly long detail constituted an unwarranted personnel action, he could have and should have instituted a CSC grievance proceeding. 5 C.F.R. § 771.302 (1974).[6] Strangely, or perhaps not so strangely, plaintiff was willing to retain his Acting Deputy General Counsel status beyond the 120 day limit and benefit thereby to the extent he retained his prospects for promotion. This extended detail also serves as a foundation for plaintiff's present claim. Having accepted the benefits of the detail, plaintiff is now estopped to attack its legality. *Steuer* v. *United States*, 207 Ct. Cl. 282 (1975); *Weir* v. *United States*, 200 Ct. Cl. 501, 511, 474 F. 2d 617, 622, *cert. denied*, 414 U.S. 1066 (1973); *Henneberger* v. *United States*, 187 Ct. Cl. 265, 267, 407 F. 2d 1340, 1341 (1969).

In addition, since plaintiff suffered no withdrawal or reduction of pay as a result of his "acting" capacity, we cannot say he was the victim of an adverse personnel action under the Back Pay Act, 5 U.S.C. § 5596(b), *supra*. Plaintiff was a free agent. He could have remained as Acting Deputy General Counsel; he could have requested to be relieved; he could have brought appropriate administrative action. He chose to stay, and cannot now be heard to contest the legality of the detail. Simply stated, plaintiff cannot have it both ways. *Steuer*, *supra; Weir*, *supra; Henneberger*, *supra*.

Plaintiff has raised other minor contentions such as the existence of an implied contract between FAA and plaintiff. He also alleged improper delays in the OST. We find no merit in these points and, therefore, reject them.

Thus we are left with the principal thrust of plaintiff's argument—the allegation that the CSC acted arbitrarily and capriciously in failing to process DOT's recommendation appointing him Deputy General Counsel.

[6] 5 C.F.R. § 771.302 (1974) provides that an employee may bring a grievance action unless specifically excepted:

"* * * this subpart [agency grievances] applies to any matter of concern or dissatisfaction to an employee which is subject to the control of agency management."

On December 27, 1968, plaintiff's proposed appointment was forwarded by the Secretary of Transportation to the CSC for appropriate and required approvals. This action took place almost two months after a national election in early November. Just a few weeks after receipt of the proposal, a new federal administration took office. Defendant argues the CSC did not have time enough to process all papers before January 20, and therefore returned the proposal concerning plaintiff, along with requests for approval of 19 other named individuals and eight requests for positions for which no appointees had been designated, to the DOT on January 22, 1969.

Plaintiff makes blunt allegations of political machinations in these actions, suggesting the CSC was thereby somehow involved in political clearances. Unfortunately for plaintiff, these allegations are totally unsubstantiated by the record before us.[7]

Plaintiff couches his charges in "arbitrary and capricious" language. He alleges the CSC acted illegally, arbitrarily and capriciously to prevent the FAA from implementing its decision to promote plaintiff. Again, there is nothing in the record which proves improper motive on the part of the two Civil Service Commissioners. All indications point to the contrary. Plaintiff's appointment to the GS–17 Deputy General Counsel position required CSC approval *both* as to (1) the availability of the GS–17 supergrade for that position, 5 U.S.C. § 5108 (1970),[8] and (2) the appointment of plaintiff to the position, 5 U.S.C. § 3324 (1970).[9]

The government submits that the CSC action in returning the Request for Approval to DOT was in no way arbitrary

[7] Interestingly, on the crucial date herein specified (January 22, 1969), the CSC consisted of one Commissioner appointed from each major political party, and one vacancy. Therefore, it would have been extremely difficult mathematically for any political party to control actions of the CSC absolutely at that particular time. Here again, the record fails to substantiate plaintiff's open suggestion of political machinations.

[8] 5 U.S.C. § 5108(a) (1970) provides in part:

"A majority of the Civil Service Commissioners may establish, and from time to time revise, the maximum number of positions * * * which may be placed in GS–16, 17, and 18 at any one time * * *. A position may be placed in GS–16, 17, or 18 only by action of, or after prior approval * * *."

[9] 5 U.S.C. § 3324(a) (1970) provides in part:

"An appointment to a position in GS–16, 17 or 18 may be made only on approval of the qualifications of the proposed appointee by the Civil Service Commission."

or capricious, and its decision to permit the new Administrator to consider the allocation of the limited number of supergrade positions available was a proper exercise of administrative discretion.

We agree. Plaintiff cites no statute or regulation forbidding the CSC from sending back the proposals in this instance. The Commissioners' action was not unreasonable, but most sensible under the circumstances. We hold the decision of the CSC to have been an eminently sound exercise of administrative discretion in no way illegal, arbitrary or capricious.[10]

Our views would be the same whether an administration changed from Party A to Party B, from Party B to Party A, or switched Presidents within the same Party.

Finally, if by any stretch of legal imagination this case should further be considered from the aspect of our "power to promote," it has long been settled law that this court will not substitute its judgment for agency discretion by ordering promotions where the agency has declined to do so. *Hirsch* v. *United States*, 205 Ct. Cl. 256, 260, 499 F. 2d 1248, 1250 (1974); *Wienberg* v. *United States*, 192 Ct. Cl. 24, 35, 425 F. 2d 1244, 1251 (1970); *Tierney* v. *United States*, 168 Ct. Cl. 77, 80 (1964).

In summary, we have here a plaintiff who is an able attorney, arguing his own case *pro se*. For reasons unknown to this court and not a part of the record, he failed of appointment to the position of FAA Deputy General Counsel. This is not the first time such an event has taken place, nor is it likely to be the last. Plaintiff was never at any time officially appointed to the higher position he now seeks. No special statute or regulation gives him entitlement to the higher office. And further, we hold the Civil Service Commission was in no way arbitrary or capricious in returning plaintiff's appointment papers, together with others, to the Department

[10] It may also be noted that the CSC action was directed to *all* supergrade appointments then pending from the DOT which negates the possibility that plaintiff's own political affiliation was in any way involved. Where there is insufficient evidence in the record as a whole to support charges of political motivation by executive agency officials, the court will not find unlawful agency action. *Schmidt* v. *United States*, 153 Ct. Cl. 407 (1961), *cert. denied*, 368 U.S. 930 (1961).

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of Transportation for appropriate resubmission after a change in administration.

Accordingly, plaintiff's motion for summary judgment is denied, defendant's cross motion for summary judgment is granted, and the petition is dismissed.

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527 F. 2d 629

GILLMORE M. PERRY v. THE UNITED STATES

[No. 802–71. Decided December 17, 1975. Plaintiff's motion for reconsideration *en banc* and for rehearing denied February 27, 1976.]

ON PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT AND DEFENDANT'S CROSS-MOTION FOR PARTIAL SUMMARY JUDGMENT

Contracts; Federal Supply Service commodity procurement contracts; regulations and decisions of Renegotiation Board re contracts exempt from renegotiation; Court of Claims jurisdiction to review.—Plaintiff, a manufacturer's representative, is given a percentage commission by various manufacturers of furniture for each contract of sale procured for them with the United States. The items are manufactured to the contractor's own design and not under Government specifications, and are procured by the Federal Supply Service (FSS) of General Services Administration through three basic buying techniques, i.e. store stock technique (under which the ultimate using agency, defense or non-defense is uncertain), and supply schedule technique and consolidated direct delivery technique (under which items may be shipped directly from the manufacturer to a defense-related agency). These techniques are described in detail in the opinion. The Renegotiation Board found that plaintiff had been given commissions on the two latter-type renegotiable contracts with FSS for direct and immediate delivery of furniture to the defense-related agencies listed in 32 C.F.R. § 1453.5(b)(8)(1974), and that plaintiff had earned excessive profits on the commissions for years 1965 through 1967. Insofar as such contracts are subject to renegotiation, the percentage commissions are also subject thereto (50 U.S.C. App. § 1213(g)(3)(A)(1970)). Plaintiff seeks a determination from this court that he did not realize excessive profits in any amount, and in his motion for summary judgment he asserts entitlement to a mandatory exemption from renegotiation under Sec. 106(a)(6) of the Renegotiation Act on the ground that the contracts do not have a direct and immediate connection with national defense. Defendant has moved for partial summary judgment in its favor and for remand to the trial division for de novo trial on the amount of plaintiff's excessive profits. It is *held* that 50 U.S.C. App. § 1216(a)(6)(1971) bars review by this court of Renegotia-

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tion Board regulation § 1453.5(b)(8) which draws a distinction between "store stock" contracts on the one hand and "supply schedule" and "consolidated direct delivery" contracts on the other, and also bars review of the Board's determination that "supply schedule" and "G.S.A. depot" contracts procured by plaintiff under which deliveries were made to the defense-related agencies listed in 32 C.F.R. § 1453.5(b)(8) had a "direct and immediate connection with the national defense." Defendant's motion for partial summary judgment is granted, and the case is remanded as requested. Plaintiff's motion for summary judgment is denied.

Court of Claims jurisdiction; renegotiation of contracts; exemptions; review of Renegotiation Board regulations and decisions.

[1] In view of the sweeping and direct language of 50 U.S.C. App. § 1216(a)(6)(1971), the Court of Claims does not have jurisdiction either to review Renegotiation Board regulation § 1453.5(b)(8) of Title 32 drawing a distinction between Federal Supply Service "store stock" contracts on the one hand and "supply schedule" and "consolidated direct delivery" contracts on the other as to their exemption from renegotiation, or to review a determination of the Board that "supply schedule" and "G.S.A. depot" contracts for the furnishing of commercial items of common use required by the Government on a recurring basis are subject to renegotiation to the extent that deliveries thereunder made to defense-related agencies listed in subparagraph 5(b)(8) have a direct and immediate connection with the national defense.

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Renegotiation of contracts; exemption from renegotiation; congressional intent.

[2] As revealed by the legislative history Congress expressly intended that the words "which do not have a direct and immediate connection with the national defense" of 50 U.S.C. App. § 1216(a)(6) are not to be construed too narrowly in connection with contracts subject to renegotiation. Under such directive, contracts for the sale of furniture, lamps, and floor coverings used by military personnel are renegotiable.

War and National Defense ⇐ 59

Judith A. Yannello for plaintiff; *John T. Koehler*, attorney of record. *Hudson, Creyke, Koehler, Brown & Tacke*, of counsel.

David R. Schlee, with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Before COWEN, *Chief Judge*, KASHIWA, and BENNETT, *Judges*.

Opinion of the Court

KASHIWA, *Judge*, delivered the opinion of the court:

This renegotiation case comes before this court on a complete stipulation of facts. Plaintiff moved for summary judgment and defendant filed a cross motion for partial summary judgment in its favor and for a remand of this matter to the Trial Division for a trial de novo on the amount of excessive profits for the fiscal years 1965, 1966, and 1967. We deny plaintiff's motion for summary judgment and allow defendant's partial motion for summary judgment, for reasons hereafter stated.

The stipulated facts show that plaintiff is a manufacturer's representative and operates as a sole proprietor; his principal place of business is in Washington, D.C. Plaintiff represented manufacturers of household furniture, decorative floor and table lamps, and floor coverings for the purpose of securing Government business. Purchases of commercial items (these items are manufactured to contractor's own design and not pursuant to Government specification) of common use needed by the Government on a recurring basis (including the commodity classes sold by plaintiff) are handled by the Federal Supply Service of the General Services Administration through three basic buying techniques which are described in detail below.

1) *Store Stock Technique.* The first technique of procurement is the purchase on a definite-quantity basis, under formally advertised, competitively awarded contracts, of items to be stored at and issued from a G.S.A. warehouse. Items so procured are commonly referred to as "store stock" since, after purchase by G.S.A., an item is shipped by the manufacturer or supplier to one or more of the numerous G.S.A. supply distribution facilities (warehouses) located throughout the United States and is there held in inventory for later re-shipment by G.S.A. upon receipt of an order from a using agency. Store stock items are listed in an annually published G.S.A. Stock Catalog (hereinafter referred to as "Stock Catalog"). This catalog serves as the primary source of information on store stock items. The Stock Catalog includes representative items of each of the commodity classes sold by plaintiff; namely, household furniture, Class 7105; lamps, Class 6230; and floor coverings, Class 7220.

2) *Supply Schedule Technique.* The second technique of procurement is the purchase on an indefinite-quantity

basis, under formally advertised, competitively awarded "requirements" contracts or (since 1968) under multiple-award, separately negotiated contracts, items used on a recurring basis by the Government which are to be shipped directly from the manufacturer to the ordering agency. In other words, G.S.A. enters into a procurement contract for these items on an indefinite-quantity basis and then an ordering agency places an order against such contract directly with the manufacturer. These items are more commonly referred to as "supply schedule" items. Information concerning supply schedule items is available through the publication and distribution of the Federal Supply Schedule. Each such schedule contains the names of the contractors, their addresses, delivery and shipping information, maximum and minimum order limitations, price, and other essential ordering information. The Supply Schedules include representative items of each of the commodity classes sold by plaintiff; namely, household furniture, Class 7105; lamps, Class 6230; and floor coverings, Class 7220. In some cases items ordered from a Supply Schedule are not shipped directly to an ordering agency but are, instead, shipped to a G.S.A. warehouse for special packing. This occurs most frequently where an item is to be shipped overseas. In such cases the purchase order received by the manufacturer will show a G.S.A. warehouse as the shipping destination and the identity of the using agency or the ordering agency in coded information such as a Basic Procurement Identification Number as set forth in ASPR 20–203, or similar coded information for agencies not covered within ASPR.

3) *Consolidated Direct Delivery Technique.* The third method of purchasing that is used by G.S.A. is the purchase by G.S.A. of items on a definite-quantity basis under fixed-price, competitively awarded contracts for direct delivery from the manufacturer or supplier to a using agency or agencies. This method is commonly referred to as the "consolidated direct delivery" method. Basically, this approach involves purchases by G.S.A. that call for shipments directly from a manufacturer to a using agency or a group of using agencies. Purchases made for consolidated direct delivery may cover items available from either the supply schedule or the stock catalog and are normally made in one of two situations. First, an agency or group of agencies may desire to order a given item in a quantity which exceeds the maximum order limitation contained in a supply schedule. Second, a group of agencies may desire to combine

their purchases of a given item in order to take advantage of the savings inherent in quantity purchases. (G.S.A., in fact, encourages agencies to combine their requirements in this fashion.) G.S.A. itself may join with another agency or group of agencies in purchase through a consolidated direct delivery in order to restock its own warehouses. In such a case, G.S.A. will add the amount of the item it desires and this amount will be delivered directly to the particular G.S.A. warehouse involved. Finally, when an item is ordered on a consolidated direct delivery basis by several agencies, the original shipment of that item by the manufacturer is sometimes made to a convenient G.S.A. warehouse, where it is then broken down, marked, and reshipped to the various ordering agencies.

The items purchased by G.S.A. through the various procurement methods described above are commodities, commonly used by the civil agencies of the Government, that are readily available through the manufacturing and distribution channels of industry. At the same time, however, the G.S.A. Store and Supply Schedule System is also used by the various military departments to satisfy their needs for these same items. G.S.A., in other words, is the supplier of common use items to the Government at large. Utilization of the G.S.A. supply system by the various military departments is in accordance with the statutory authority of 10 U.S.C. § 2308 (1970) which provides that agencies and military departments may enter into interdepartmental purchasing agreements. The agreements between G.S.A. and the Department of Defense and military departments are implemented in Section V of the Armed Services Procurement Regulations. Essentially the commodity assignments are based on subject matter lines. The stipulation contains further details regarding preferred use of the various techniques, catalogues, changes in catalogue listing, dual listing, split listing, and other details.

Pursuant to Section 106(a)(6) of the Renegotiation Act of 1951,[1] the Board has issued detailed regulations setting forth mandatory exemptions from renegotiation for those contracts not having a "direct and immediate connection with the national defense." 32 C.F.R. § 1453.5 (1974). In particular, the

[1] 50 U.S.C. App. § 1216(a)(6) (1971).

Board has granted such a mandatory exemption by regulation to certain contracts with G.S.A. 32 C.F.R. § 1453.5(b)(8) (1974).[2] This regulation first exempts all contracts of the Public Buildings Service and the National Archives and Records Service. It further exempts all Federal Supply Service "store stock" contracts. Finally, it exempts all FSS "supply schedule" and "consolidated direct delivery" contracts to the extent that deliveries thereunder are made to agencies *other than* the following:

1) Department of Defense
2) Department of the Army
3) Department of the Navy
4) Department of the Air Force
5) Atomic Energy Commission
6) National Aeronautics and Space Administration

Thus, FSS "supply schedule" and "consolidated direct delivery" contracts are subject to renegotiation to the extent that deliveries thereunder are made to the above-named agencies.

In issuing this regulation, the Board has in effect stated that, insofar as the sale of furniture or other items purchased by FSS is concerned, those contracts where it is known at the outset that the items will go to the listed defense agencies have a "direct and immediate connection with the national defense" within the meaning of the Act, while those contracts where it is not so known do not have a "direct and immediate connection with the national defense" within the meaning of the Act.

The plaintiff is a "manufacturer's representative" who is given a percentage commission by various manufacturers of furniture for each contract for the sale of furniture which he is able to procure for them with the United States. Insofar as the contracts which he procures for his clients are subject to renegotiation, the percentage commissions which he is given are also subject to renegotiation. 50 U.S.C. App. § 1213(g)(3)(A) (1970). The Board found that plaintiff had been given commissions on renegotiable contracts with FSS for the direct and immediate delivery of furniture to

[2] This regulation was first issued on March 25, 1952, 17 Fed. Reg. 2519, and in all respects material to this case has remained the same ever since.

the defense-related agencies listed in 32 C.F.R. § 1453.5(b) (8) (1974). Plaintiff alleges in his petition that the Board found that plaintiff had earned excessive profits on these commissions for the years 1965 through 1967 in the following amounts:

Year:	*Net Renegotiable Profit*	*Excessive Profit*
1965	$246, 751. 01	$135, 000. 00
1966	233, 854. 62	145, 000. 00
1967	219, 568. 77	125, 000. 00

Plaintiff's renegotiable commissions were received with respect to two kinds of contracts. The bulk of the commissions was received for the procurement of FSS "supply schedule" contracts where deliveries of furniture were made directly and immediately from the manufacturer to one of the defense-related agencies listed in 32 C.F.R. § 1453.5(b) (8) (1974). The balance of the commissions was received for the procurement of "G.S.A. depot" contracts, which were in fact FSS "supply schedule" contracts, where deliveries were made from the manufacturer to a G.S.A. Supply Center for special packing and direct and immediate reshipment (usually overseas) to one of the defense-related agencies listed in 32 C.F.R. § 1453.5(b) (8) (1974).

Under each of the contracts which the Board determined to be renegotiable, plaintiff knew or should have known that the items were destined for one of the defense-related agencies listed in 32 C.F.R. § 1453.5(b) (8) (1974). Obviously he knew where the "supply schedule" items were destined because delivery of those items was made directly to the ordering agency. Similarly he knew, or should have known, also, where the "G.S.A. depot" items were destined because *at the very least* the Basic Procurement Identification Number of the ordering agency was set forth on the purchase order. ASPR 20-203 requires that this Basic Procurement Identification Number be placed upon each purchase order which is issued by a defense-related agency.

The Board's determination of excessive profits for the years 1965 through 1967 was rendered on August 4, 1971, and plaintiff's petition in this court seeking a de novo redetermination of its excessive profits for these years was filed on November 1, 1971.

The relevant portions of 50 U.S.C. App. § 1216(a)(6) (1971)[3] and 32 C.F.R. § 1453.5(b)(8) (1974)[4] are quoted in the margin.

The question presented is whether 32 C.F.R. § 1453.5(b)(8) (1974) and the Renegotiation Board's determination thereunder that a contract is or is not exempt may be reviewed or redetermined by the Court of Claims.

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[3] 50 U.S.C. App. § 1216(a)(6) (1971) provides as follows:

"§ 1216. Exemptions.

"(a) Mandatory Exemptions. The provisions of this title [sections 1211 to 1224 of this Appendix] shall not apply to

* * * * *

"(6) any contract which the Board determines does not have a direct and immediate connection with the national defense. The Board shall prescribe regulations designating those classes and types of contracts which shall be exempt under this paragraph; and the Board shall, in accordance with regulations prescribed by it, exempt any individual contract not falling within any such class or type if it determines that such contract does not have a direct and immediate connection with the national defense. In designating those classes and types of contracts which shall be exempt and in exempting any individual contract under this paragraph, the Board shall consider as not having a direct or immediate connection with national defense any contract for the furnishing of materials or services to be used by the United States, a Department or agency thereof, in the manufacture and sale of synthetic rubbers to a private person or to private persons which are to be used for nondefense purposes. If the use by such private person or persons shall be partly for defense and partly for nondefense purposes, the Board shall consider as not having a direct or immediate connection with national defense that portion of the contract which is determined not to have been used for national defense purposes. The method used in making such determination shall be subject to approval by the Board. Notwithstanding section 108 of this title [section 1218 of this Appendix], regulations prescribed by the Board under this paragraph, and any determination of the Board that a contract is or is not exempt under this paragraph shall not be reviewed or redetermined by the Court of Claims or by any other court or agency;"

[4] 32 C.F.R. § 1453.5(b)(8) (1974) provides as follows:

"§ 1453.5. Contracts that do not have a direct and immediate connection with the national defense.

* * * * *

"(b) *Exemptions.* Subject to the limitation provided in paragraph (c) of this section, the Board has determined that the following classes and types of prime contracts do not have a direct and immediate connection with the national defense:

* * * * *

"(8) *General Services Administration.* All contracts of the Public Buildings Service and the National Archives and Records Service, General Services Administration; all contracts of the Federal Supply Service, General Services Administration, for store stock to be delivered to its Supply Centers; and all Federal Supply Schedule contracts and consolidated direct delivery contracts of the Federal Supply Service, General Services Administration, to the extent that deliveries thereunder are made to agencies of the Government other than the Department of Defense, Department of the Army, Department of the Navy, Department of the Air Force, Atomic Energy Commission, National Aeronautics and Space Administration and with respect to deliveries made before January 1, 1957, United States Coast Guard."

The Renegotiation Act of 1951 states that it shall not apply to contracts which "the Board determines" do not have "a direct and immediate connection with the national defense." 50 U.S.C. App. § 1216(a)(6)(1971). The Act further provides:

> * * * regulations prescribed by the Board under this paragraph, and any determination of the Board that a contract is or is not exempt under this paragraph, shall not be reviewed or redetermined by the Court of Claims or by any other court or agency; * * * ["Court of Claims" inserted in lieu of "Tax Court" by 1971 amendment.]

Although this statutory language of 50 U.S.C. App. § 1216(a)(6) (1971) has been repeatedly held under prior decisions hereafter mentioned to preclude any judicial review whatsoever of any Board regulations or determinations under the subject provision of the Act, plaintiff argues that we re-examine these cases.

In *Litton Industries* v. *Renegotiation Board*, 36 T.C. 431, 433 (1961), *aff'd*, 298 F. 2d 156 (4th Cir. 1962), it was held:

> Section 108 of the Renegotiation Act of 1951 gave the Tax Court such jurisdiction as it has to review determinations of the Renegotiation Board. Section 106(a)(6) expressly provides that, notwithstanding section 108, the Tax Court shall not have any jurisdiction to review or redetermine any determination of the Renegotiation Board that a contract is or is not exempt under subsection (a) of section 106 or to review or redetermine the regulations prescribed by the Board under section 106(a)(6). It seems clear that the Tax Court has no jurisdiction to take any of the actions sought by the petitioner in this case, and it must leave the parties as it found them. Cf. *Nathan Cohen* v. *Secretary of War*, 7 T.C. 1002.

In *List & Clark Construction Co.* v. *Renegotiation Board*, 35 T.C. 823, 832 (1961), the court stated:

> Paragraph (6) of section 106(a) exempts "any contract which the Board determines does not have a direct and immediate connection with the national defense," and further provides that "any determination of the Board that a contract is or is not exempt under this paragraph, shall not be reviewed or redetermined by the Tax

Court or by any other court or agency." The petitioner objects that the Board's ruling does not expressly state that the contract "is not exempt under paragraph (6)" of section 106(a), and therefore is reviewable by this Court. It is evident, however, that the Board's denial related to the contention that the contract was not connected with national defense. To the extent the Board's action related to this point we are without authority to review it. The cases cited by the petitioner, *Vaughn Machinery Co.* v. *Renegotiation Board*, 30 T.C. 949, and *Golbert* v. *Renegotiation Board*, 28 T.C. 728, did not involve paragraph (6).

In *Baltimore Contractors, Inc.* v. *Renegotiation Board*, 383 F. 2d 690, 693–94 (4th Cir. 1967), the court stated:

> The Act was intended to reach only contracts having a direct and immediate relation to national defense. The Renegotiation Board was authorized to adopt regulations defining general exemptions and, under § 106(a)(6), to exempt individual contracts having no such relation. There is no provision for a hearing, and the Board's decision is final and unreviewable.
>
> In *Litton Indus. of Md.* v. *Renegotiation Bd.*, 4 Cir., 298 F. 2d 156, we held that this scheme did not amount to constitutional deprivation of a contractor who sought to have a contract treated as renegotiable. The theory was that the government is under no constitutional compulsion to provide any remedy for the enforcement of a right it has created against itself. * * * [Footnote omitted.]

It is our opinion that the view expressed by these three cases has been further supported by the very recent decision in *Weinberger* v. *Salfi*, 422 U.S. 749 (1975). In that case a Federal district court took jurisdiction of a Social Security case under the general Federal question statute, 28 U.S.C. § 1331 (1970), in spite of a provision expressly prohibiting a section 1331 action The Court held that such jurisdiction over suits seeking to recover Social Security benefits under section 1331 was barred by the strong, compelling, prohibitive language in the statute. The Court held at 756–59:

> The third sentence of 42 U.S.C. § 405(h) provides:
>
> "No action against the United States, the Secretary, or any officer or employee thereof shall be brought under

[§§ 1331 *et seq.*] of Title 28 to recover on any claim arising under [Title II of the Social Security Act]."

On its face, this provision bars district court federal question jurisdiction over suits, such as this one which seek to recover Social Security benefits. Yet it was § 1331 jurisdiction which appellees sucessfully invoked in the District Court. That court considered this provision, but concluded that it was inapplicable because it amounted to no more than a codification of the doctrine of exhaustion of administrative remedies. The District Court's reading of § 405(h) was, we think, entirely too narrow.

That the third sentence of § 405(h) is more than a codified requirement of administrative exhaustion is plain from its own language, which is sweeping and direct and which states that no action shall be brought under § 1331, not merely that only those actions shall be brought in which administrative remedies have been exhausted. Moreover, if the third sentence is construed to be nothing more than a requirement of administrative exhaustion, it would be superfluous. This is because the first two sentences of § 405(h), which appear in the margin, assure that administrative exhaustion will be required. Specifically, they prevent review of decisions of the Secretary save as provided in the Act, which provision is made in § 405(g). The latter section prescribes typical requirements for review of matters before an administrative agency, including administrative exhaustion. Thus the District Court's treatment of the third sentence of § 405(h) ignored not only that sentence's plain language, but also relegated it to a function which is already performed by other statutory provisions. [Footnotes omitted.] [Emphasis supplied.]

We note that the statute in the present case prohibits in equal "sweeping and direct" language a review or redetermination by the Court of Claims. It is our opinion that the view expressed in *Litton Industries*, *List & Clark Construction Co.*, and *Baltimore Contractors, Inc.* is compelled by the direct language of the statute, and this is well supported by the Court in *Weinberger*.

We, therefore, hold that the Board's regulation drawing a distinction between "store stock" contracts on one hand and "supply schedule" and "consolidated direct delivery" contracts on the other may not be reviewed in this court. We also hold that the Board's determination that "supply schedule" and "G.S.A. depot" contracts procured by plaintiff wherein

deliveries were made to the defense-related agencies listed in 32 C.F.R. § 1453.5(b)(8) (1974) had a "direct and immediate connection with the national defense" is also not reviewable in this court.[5]

Plaintiff relies heavily upon the fact that determinations of the Civil Service Commission under the Civil Service Retirement Act, 5 U.S.C. § 2266(c) (1964), are subject to a limited judicial review, even though the statute states that the determinations of disability shall be "final and conclusive and shall not be subject to review." *Gaines* v. *United States*, 158 Ct. Cl. 497 (1962), *cert. denied*, 371 U.S. 936 (1962); *McGlasson* v. *United States*, 184 Ct. Cl. 542, 397 F. 2d 303 (1968). However, that statute speaks in terms which are not nearly as explicit as the one presently before the court. In *Gaines* v. *United States*, 158 Ct. Cl. 497, 502, *cert. denied*, 371 U.S. 936 (1962), this court stated:

> * * * At most, a court can set the Commission's determination aside (or refuse to recognize it as valid)

[5] We find an appropriate parallel in the statutory provision precluding judicial review of determinations of the Veterans Administration on claims for veterans benefits. 38 U.S.C. § 211(a) (1970). This statute provides that decisions of the Veterans Administrator regarding claims for benefits are final and conclusive and further provides that no court shall have the power or jurisdiction to review any such decision. This court held in *Brown* v. *United States*, 150 Ct. Cl. 836, 840 (1960), that such statutory language fully precludes any judicial review whatsoever of the decision of the Veterans Administrator denying a claim for veterans benefits. This court's rule in the *Brown* case has been repeatedly upheld by other federal courts. *DeRodulfa* v. *United States*, 461 F. 2d. 1240 (D.C. Cir. 1972), *cert. denied*, 409 U.S. 949; *Fritz* v. *Veterans Administration*, 427 F. 2d 154 (9th Cir. 1970); *Wickline* v. *Brooks*, 446 F. 2d 1391 (4th Cir. 1971), *cert. denied*, 404 U.S. 1061 (1972); *Redfield* v. *Driver*, 364 F. 2d 812 (9th Cir. 1966); *Barefield* v. *Byrd*, 320 F. 2d 455 (5th Cir. 1963), *cert. denied*, 376 U.S. 928 (1964).

In *Tracy* v. *Gleason*, 379 F. 2d 469 (D.C. Cir. 1967), it was held that 38 U.S.C. § 211(a) (1970) does not preclude review of an administrative decision on a matter not involving a "claim for benefits or payments." This decision did not, of course, hold that judicial review could be had of administrative determinations which were *within* the meaning of the statute. In other words, it only served to limit the number of decisions for which no judicial review could be had but left intact the rule that where there was an administrative determination on a claim for benefits or payments, that decision could not be reviewed. Further, in *DiSilvestro* v. *United States*, 405 F. 2d 150, 155 (2d Cir. 1968), *cert. denied*, 396 U.S. 964 (1969), it was held that 38 U.S.C. § 211(a) (1970) does not preclude judicial review of the *Government's* claim for affirmative relief from a veteran for obtaining benefits fraudulently. Again, this does not disturb the basic rule that the administrative determination of eligibility for benefits is not reviewable. Finally, in *Johnson* v. *Robison*, 415 U.S. 361, 373 (1974), it was held that 38 U.S.C. § 211(a) (1970), does not preclude judicial review of the constitutionality of veterans benefits legislation. Again, this does not disturb the rule that decisions on claims for benefits made *under* the statute are not reviewable.

> only where there has been a substantial departure from important procedural rights, a misconstruction of the governing legislation, or some like error "going to the heart of the administrative determination."

It was our view that a limited review may be allowed under the language in the Civil Service case. But here, in this case, the language used by Congress is much more compelling and prohibitive. The Board's regulations and determinations "*shall not be reviewed or redetermined by the Court of Claims or by any other court or agency.*" 50 U.S.C. App. § 1216(a)(6) (1971). [Emphasis supplied.] In these circumstances, the authorities cited by plaintiff that determinations of disability shall not be final and conclusive and subject to review are plainly inapposite.

There are various arguments submitted by plaintiff to show that unjust results will follow if plaintiff's commissions in this case are held to be subject to renegotiation. We do not agree. Plaintiff argues that the Board's determination under the regulations as to which contracts had a direct and immediate connection with the national defense is improper. However, under the "supply schedule" contracts, items were shipped directly from the manufacturer to a defense-related agency. Also, under the "G.S.A. depot" contracts even though the items went to G.S.A. Supply Centers for special packing, the manufacturer had the ability to know that the order was from a defense-related agency because the order set forth the Basic Procurement Identification Number. It is equally appropriate for the Board to conclude that "store stock" contracts do not have a direct and immediate connection with the national defense because of the uncertainty as to what using agency, defense or non-defense, will ultimately order the items delivered thereunder. Plaintiff also argues that the furniture, lamps, and floor coverings involved are not war materiel. Congress expressly intended that "[t]he words 'which do not have a direct and immediate connection with the national defense' *are not to be construed too narrowly.*" 97 Cong. Rec. 2254 (1951) (remarks of Senator George). [Emphasis supplied.] In fact, as Senator George stated, contracts for the construction of *houses* in the United States for *civilian* defense workers would be subject to renegotiation.

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Therefore, furniture, lamps, and floor coverings used by military personnel should also be renegotiable.

Defendant's motion for partial summary judgment is granted and we remand this case to the Trial Division for a trial de novo on the amount of excessive profits for the fiscal years involved. Plaintiff's motion for summary judgment is denied.

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527 F. 2d 1213

NEWPORT NEWS SHIPBUILDING AND DRY DOCK COMPANY v. THE UNITED STATES

[No. 341–74. Decided December 17, 1975]

ON PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT

Renegotiation of contracts; renegotiation proceedings; excessive profits determination; limitations period; discharge of liability.—Plaintiff seeks determination by this court that it has no liability for excessive profits for its fiscal year ended December 31, 1957. Plaintiff constructs and designs oil tankers, passenger and cargo ships, vessels for the United States, etc. During fiscal year ended December 31, 1957, plaintiff's renegotiable business consisted of continuation and completion of construction of certain vessels for the United States. In 1958 administrative proceedings concerning plaintiff's renegotiable income were instituted; however, the parties agreed to a series of extensions of the statutory period for completion of the proceeding necessitated by plaintiff's appeal to the Armed Services Board of Contract Appeals and this court (see opinion of the court dated March 17, 1967, 179 Ct. Cl. 97, 374 F. 2d 516) respecting the amount to which plaintiff was entitled under the price adjustment provision of its contract for construction of the aircraft carrier Ranger. During pendency of the escalation claim, the New York Regional Renegotiation Board determined that plaintiff's overall renegotiable profits for 1957 were reasonable, but that any additional renegotiable profits applicable to 1957 thereafter received by plaintiff as a result of its escalation claim would be considered excessive profits. In April 1972 the Navy paid plaintiff $7,284,236.45 on its escalation claim, the ASBCA having found that under applicable guidelines receipt by plaintiff of the full amount of the escalation adjustment would result in a minimum fair and reasonable profit on the Ranger contract. Although plaintiff reminded the Renegotiation Board of the limitations period for completion of the proceedings, the period expired without an order or agreement determining plaintiff's liability for excessive profits or an extension of the period. It is *held* that the limitations period was not extended by mutual agreement beyond June 30, 1973 and ac-

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cordingly plaintiff's liability for excessive profits, if any, was discharged by operation of 50 U.S.C. App. § 1215(c). Plaintiff's motion for summary judgment on Count 1 of its petition is granted; this disposes of the case.

Renegotiation of contracts; redetermination of excessive profits; concurrent proceedings before ASBCA and Renegotiation Board.

[1] Where price redetermination proceedings were concurrently before the Armed Services Board of Contract Appeals concerning plaintiff's entitlement to upward adjustment of contract price by reason of changes in material and labor costs during performance of a shipbuilding contract and the reasonableness of plaintiff's profits, and before the Renegotiation Board concerning plaintiff's liability for all excessive profits received or accrued during the fiscal year in issue of which a portion related to said shipbuilding contract, under existing law neither one pre-empted the other, and until the renegotiation limitations period expired as provided in 50 U.S.C. App. § 1215(c) the Renegotiation Board had an active right to propose an excessive profits figure, subject to de novo redetermination before this court.

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Renegotiation of contracts; redetermination of excessive profits; Renegotiation Board proceedings; limitations period; extension of period; conduct of parties.

[2] Where the parties entered into a series of formal mutual written agreements extending the limitations period for issuance of an order redetermining plaintiff's excessive profits, a statement by plaintiff that it would grant any necessary extension of time for issuance of the order pending resolution of plaintiff's concurrent claim before the Armed Services Board of Contract Appeals does not comport with the parties' course of conduct in executing the formal extension agreements and cannot be considered a "mutual agreement" to extend the limitations period within the meaning of 50 U.S.C. App. § 1215(c).

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Renegotiation of contracts; redetermination of excessive profits; Renegotiation Board proceedings; limitations period; discharge of liability.

[3] Absent fraud, malfeasance or willful misrepresentation of a material fact, where the Renegotiation Board within the 2-year statutory period after commencement of renegotiation proceedings and within the time as extended by a series of formal mutual written agreements failed to issue an order determining plaintiff's excessive profits for the fiscal year in issue, plaintiff's liability for excessive profits received or accrued during said year was discharged by operation of 50 U.S.C. App. § 1215(c). The language of the statute is unequivocal that if a renegotiation proceeding is not concluded by agreement or order within 2 years after commence-

ment of the proceedings (or within such time as the parties have mutually agreed to), the contractor's liability is discharged. The congressional intent in enacting the legislation was to encourage the speedy resolution of potentially time-consuming cases and to protect contractors from protracted renegotiation proceedings.

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K. Martin Worthy, attorney of record for plaintiff. *Lee I. Park*, *Gerald D. Morgan*, *John G. DeGooyer*, and *Hamel, Park, McCabe & Saunders*, of counsel.

Frank H. Clabaugh, with whom was *Assistant Attorney General Rex E. Lee*, for defendant. *Bernard M. Brodsky*, of counsel.

Before DURFEE, *Senior Judge*, NICHOLS, and KASHIWA, *Judges*.

NICHOLS, *Judge*, delivered the opinion of the court:

This case involves renegotiation proceedings, commenced in 1958, pursuant to the Renegotiation Act of 1951, as amended, 50 U.S.C. App. § 1211, et seq., for plaintiff's fiscal year ending December 31, 1957. Plaintiff and defendant executed a series of written agreements to extend the statute of limitations prescribed in section 105(c) of the Renegotiation Act of 1951, 50 U.S.C. App. § 1215(c); however, the last agreement expired on June 30, 1973. The Renegotiation Board issued an order against Newport News determining excessive profits, within the meaning of the Renegotiation Act, for plaintiff's fiscal year ending December 31, 1957, in the gross amount of $1,000,000, but did so on June 25, 1974, a year after the last agreement between plaintiff and defendant extending the statute of limitations had expired. Plaintiff filed suit in this court on September 20, 1974, contesting the Renegotiation Board's determination and thereafter moved for summary judgment. In Count 1 of its petition plaintiff urged that when the statutory period, as extended by mutual agreement, for completion of the renegotiation of plaintiff's fiscal year 1957, expired on June 30, 1973, without an agreement or order determining plaintiff's liability for excessive profits, if any, for fiscal year 1957, plaintiff's liability was thereupon discharged by operation of section

105(c) of the Renegotiation Act. We agree, and therefore grant plaintiff's motion for summary judgment on Count 1. This in effect disposes of the entire case.

I.

The events that led to the controversy were as follows: Plaintiff, Newport News Shipbuilding And Dry Dock Company (the contractor) is a corporation engaged in the construction and design of oil tankers, passenger and cargo ships, major Navy ships, the conversion and repair of such ships, and the manufacture of hydraulic turbines and other equipment for hydroelectric plants, pressure vessels for refineries and chemical plants, and paper and pulp mill machinery and castings. During the fiscal year ending December 31, 1957, plaintiff's renegotiable business consisted of the substantial completion of the aircraft carrier RANGER, continuation of the contractor's activities in the design, development and construction of a prototype nuclear reactor for the propulsion of large surface ships, continuation of construction of two LST's for the Navy, construction and completion of two passenger-cargo vessels for Grace Lines, Inc., continued construction of the FORRESTAL, new construction on the nuclear attack submarine SHARK and the nuclear-powered aircraft carrier ENTERPRISE and general ship repair and conversion. On June 24, 1958, the statutory Renegotiation Board assigned the renegotiation of plaintiff's renegotiable income for 1957 to the New York Regional Renegotiation Board, which commenced proceedings by sending notice, as required by section 105(a) of the Renegotiation Act, 50 U.S.C. App. § 1215(a), by registered mail to plaintiff on June 30, 1958.

Extensive correspondence between plaintiff and the Regional Board followed. On January 20, 1960, plaintiff, at the request of the Board, duly executed an agreement with the Regional Board extending the statutory period for completion of the 1957 renegotiation proceedings to December 31, 1960. The extension was necessary because of 50 U.S.C. App. § 1215(c), which reads as follows:

> * * * If an agreement or order determining the amount of excessive profits is not made within two years

following the commencement of the renegotiation proceeding, then, in the absence of fraud or malfeasance or willful misrepresentation of a material fact, upon the expiration of such two years all liabilities of the contractor or subcontractor for excessive profits with respect to which such proceeding was commenced shall thereupon be discharged, except that * * * such two-year period may be extended by mutual agreement.

The renegotiation proceedings had bogged down because of a controversy between plaintiff and the Navy over the amount to which plaintiff was entitled under a contract it had with the Navy, dated February 3, 1954, (NObs-3557) for the construction of the aircraft carrier RANGER. Article 6 of the contract provided that the total fixed price would be subject to adjustment, upward or downward, for changes in material and labor costs, to be determined on the basis of industry cost indices computed by the Department of Labor. Pursuant to this provision, plaintiff filed an escalation claim with the Navy on September 30, 1958, seeking an adjustment of $7,284,236.45, of which $2,192,582.50 was included as income for 1957. But the contract further provided that the Contracting Officer might deny an upward adjustment if he should find that it was "not required, in whole or in part, to enable the contractor to earn a fair and reasonable profit under the contract." By letter dated June 1, 1960, the Contracting Officer denied the adjustment in full on the ground that the profit already accrued was fair and reasonable. Plaintiff appealed the decision to the Armed Services Board of Contract Appeals (ASBCA) in June 1960.

Pending the outcome of the ASBCA decision, plaintiff, at the request of the New York Regional Board, executed several more agreements extending the statutory limitations period as follows:

DATE OF AGREEMENT	DATE OF EXPIRATION OF STATUTE OF LIMITATIONS
July 25, 1960	September 30, 1961
May 24, 1961	December 31, 1961
July 25, 1961	June 30, 1962

The Regional Board determined meanwhile that plaintiff's overall renegotiable profits for 1957 were reasonable, but that any additional renegotiable profits applicable to 1957 there-

after received by plaintiff as a result of its escalation claim would be considered excessive profits. The Regional Board offered plaintiff a conditional clearance to this effect, which the plaintiff refused and the case was thereafter, in November 1961, forwarded to the Statutory Renegotiation Board.

The Statutory Renegotiation Board and plaintiff, at the Board's request, executed a further series of agreements extending the statute of limitations period as follows:

DATE OF AGREEMENT	DATE OF EXPIRATION OF STATUTE OF LIMITATIONS
May 2, 1962	December 31, 1962
December 11, 1962	March 29, 1963
February 19, 1963	June 28, 1963

While the case was pending before the top Renegotiation Board, ASBCA on February 28, 1962, denied the contractor's claim. 1962 BCA ¶3306. Plaintiff appealed to this court to reverse the ASBCA decision. The said Board, on February 14, 1963, after meeting with the contractor and visiting the shipyard, determined that the contractor's reported renegotiable profits, exclusive of escalation, were reasonable, but that any profits thereafter received from the escalation claim would be considered as excessive profits to be refunded to the Government. The Board offered to enter into a conditional clearance agreement pursuant to Part 1473 of the Renegotiation Board Regulations with the contractor implementing its determination and at plaintiff's request issued a written summary of the facts and reasons supporting its decision.

By letter dated March 29, 1963, plaintiff advised the Board that it did not wish to enter into the proposed conditional clearance agreement. The contractor had appealed the decision to this court and was awaiting a decision on its claim. The contractor wrote:

> Your letter also states that the determination of the Board is conditioned upon this Company's being successful in its claim for escalation under Contract NObs–3557. We would like to suggest again that because of the contingent nature of the determination it is not necessary for the Renegotiation Board to issue an order at this time. Rather it would seem appropriate to delay the

order until the escalation matter is finally settled. We will grant any necessary extension of time for such purposes.

The Board responded to plaintiff by letter dated April 17, 1963, stating in pertinent part:

> You propose that the Board delay its determination by deferring the issuance of a unilateral order for 1957 because of your claim for escalation in connection with the construction of the Ranger.
>
> The Board has carefully considered your proposal, particularly in light of your offer to execute appropriate agreements extending the time in which the 1957 renegotiation proceeding may be completed. The Board has determined that it will defer the issuance of the order.
>
> Please keep the Board advised of all pertinent developments in the Ranger escalation claim.

By letter dated April 23, 1963, plaintiff responded:

> We shall keep the Board advised of all developments as to the claim for escalation on the Ranger contract. We will also execute any agreements necessary to extend the time within which the 1957 renegotiation proceedings may be completed.

Thereafter the Renegotiation Board and plaintiff, each time at the Board's request, executed eight agreements extending the statutory period for completion of the 1957 renegotiation proceedings as follows:

DATE OF AGREEMENT	DATE OF EXPIRATION OF STATUTE OF LIMITATIONS
May 16, 1963	June 30, 1964
April 21, 1964	June 30, 1965
June 7, 1965	June 30, 1966
June 2, 1966	June 30, 1967
May 24, 1967	July 1, 1968
June 4, 1968	July 1, 1969
May 29, 1969	July 1, 1971
June 2, 1971	June 30, 1973

The June 2, 1971 agreement extending the statute of limitations to June 30, 1973, was the last agreement requested by the Board and thereafter, no further written agreement was executed by the parties.

The extension agreements were necessary because the RANGER escalation claim was pending before this court. Our decision issued March 17, 1967, *Newport News Shipbuilding & Dry Dock Co.* v. *United States*, 179 Ct. Cl. 97, 374 F. 2d 516. After examining the events that led to the controversy and the applicable contract provisions and the Armed Services Procurement Regulations we suspended further proceedings before us to permit the ASBCA to determine the reasonableness of plaintiff's profits in light of the guidelines set forth in the Armed Services Procurement Regulations, 32 C.F.R. (Rev. 1954, Cum. Supp., Jan. 1960), §§ 3.808–1 and 3.808–2. We held that the Board's failure to show that it had followed these guidelines was an error requiring a quasi remand of the type then usual.

In light of the court's instructions, the ASBCA held supplemental proceedings and thereafter, on January 27, 1971, issued a new opinion finding that under the applicable guidelines, receipt by the plaintiff of the full amount of the escalation adjustment would result in a "minimum fair and reasonable profit" on the RANGER contract. 71–1 BCA ¶8705. The ASBCA decision was reaffirmed on August 17, 1971, when the Navy's motion for reconsideration was denied. Finally, in April 1972, the Navy paid the $7,284,236.45 in dispute to the Newport News Company.

At this point the Renegotiation Board proceedings to determine plaintiff's liability for excessive profits for fiscal year 1957 were still pending. The statute of limitations had been extended by mutual written agreement to June 30, 1973, allowing the Board to issue an order prior to that point, although well over two years had passed since the renegotiation proceedings commenced. On April 20, 1972, the Assistant to the General Counsel, Department of the Navy, informed the Renegotiation Board that the Navy had paid the escalation claim. Thereafter by letter dated June 15, 1972, plaintiff also advised the Board that the escalation claim had been settled and requested reconsideration of its case in light of the subsequent developments. Essentially, plaintiff contended that since the ASBCA had determined that its profits under the RANGER contract were reasonable (therefore allowing an escalation adjustment), the Renegotiation Board

should conclude that it did not realize excessive profits for 1957. In the first paragraph of its letter, plaintiff specifically noted that "the time for completion of renegotiation for said year [1957] has been extended to June 30, 1973." On October 24, 1972, plaintiff submitted a statement summarizing the findings of the ASBCA as they related to each of the statutory factors in the Renegotiation Act and asked for a clearance for its fiscal year 1957. On December 19, 1972, plaintiff's representatives met with Renegotiation Board officials regarding the 1957 proceedings.

No further communication between plaintiff and defendant took place until October 17, 1973, when the Renegotiation Board sent a letter to plaintiff suggesting a hearing. Meanwhile, however, on June 30, 1973, the statute of limitations expired without an order or agreement determining plaintiff's liability for excessive profits or extending time. Defendant alleges that it was in the process of changing its record keeping from manual to computer operations and that the June 30, 1973, expiration date was never transferred to the computer. Further, defendant offers by way of explanation that the reviewer assigned to the case died prior to the June 1973 expiration. In the absence of fraud or malfeasance or willful misrepresentation of a material fact, none of which are alleged, we do not think the reason for the error is material.

After receiving defendant's October 17, 1973, letter, plaintiff informed the Board that the statute of limitations had expired, thus discharging plaintiff's liability. Plaintiff consented, by letter dated November 20, 1973, to meet with the Board on January 10, 1974, to discuss the merits of the case, with the understanding that it did not waive its contention that the statute of limitations had expired.

On June 11, 1974, the Renegotiation Board issued a Proposed Opinion that plaintiff realized excessive profits in the amount of $1,000,000 for fiscal year 1957 and requested plaintiff to advise the Board whether it was willing to enter into an agreement. By letter dated June 20, 1974, plaintiff refused to enter into an agreement. Thereafter, on June 25, 1974, the Renegotiation Board issued a unilateral order against Newport News in the gross amount of $1,000,000.

The Board allocated only a part of the additional revenues resulting from the escalation claim to plaintiff's 1957 year and retreated from its original position to the extent of holding only part, not all, of the portion allocated to 1957 to constitute excessive profit. It should be noted that the issues before the ASBCA and the Renegotiation Board were not the same. The ASBCA dealt with revenues from the RANGER contract only, to whatever fiscal years allocated, while the Renegotiation Board dealt with all receipts and accruals for 1957, on an over-all fiscal year basis, not only the allocable portion of RANGER revenues, but other revenues as well. It may seem anomalous to have two sets of price redetermination procedures apply in part to the same contract revenues, but under existing law, neither one pre-empts the other. See our discussion of this problem in *Newport News*, *supra*. Until limitations ran, it cannot be blinked that the Board had an active right to propose its $1,000,000 figure, subject of course to *de novo* redetermination here.

Plaintiff filed suit in this court on September 20, 1974. The only issue before the court at this time is whether plaintiff's liability for excessive profits for fiscal year 1957 has been discharged by operation of section 105(c) of the Renegotiation Act.

II.

The Renegotiation Act of 1951, as amended, is a reflection of the Congressional policy that excessive profits realized by government contractors in the performance of contracts relating to the national defense should be eliminated. 50 U.S.C. App. § 1211. The Act details the nature of the proceedings to be conducted by a Renegotiation Board, 50 U.S.C. App. § 1215, and specifically notes the factors to be considered by the Board in its determination of a contractor's liability for excessive profits. 50 U.S.C. App. § 1213(e). A statutory limitations period is written into the Act as quoted, *supra*.

There is no allegation in this case of fraud, malfeasance or willful mispresentation of a material fact. Further, it is clear that no agreement or order determining excessive profits was issued within two years following the commencement of the renegotiation proceeding. The question then is whether the limitations period was extended by "mutual agreement"

within the meaning of the statute. The parties did execute a series of written mutual agreements extending the statute of limitations to June 30, 1973. If the Board had issued its order prior to that date, plaintiff's argument would be unmeritorious as the statute specifically provides that the limitations period may be extended by mutual agreement. However, the Board did not issue its order until June 25, 1974. Plaintiff contends that its liability is therefore discharged. Defendant argues that a formal extension was not necessary because the plaintiff had agreed in 1963 to execute whatever extensions were necessary. Defendant also argues that equitable estoppel and implied waiver should be applied to toll the statute of limitations.

The language of the statute is unequivocal. If a renegotiation proceeding is not concluded by agreement or order within two years after the commencement of the proceedings (or within such time as the parties have mutually agreed to), the contractor's liability is "discharged." An examination of the legislative history of the Act reveals a Congressional intent to protect contractors from renegotiation proceedings that might continue indefinitely.

The first renegotiation law, passed in 1942 as § 403 of the Sixth Supplemental National Defense Appropriation Act (Pub. L. 528, 56 Stat. 244) did not contain any statute of limitations provision. The law was amended six months later in the Revenue Act of 1942 to eliminate some of the uncertainties in the practical administration of the legislation. One of the most frequent objections to the original Act was that contracts remained subject to renegotiation until three years after the war. Hearings before the Subcommittee of the Finance Committee, U.S. Senate, 77th Cong., 2nd Sess., on § 403 of Pub. L. 528, September 29–30, 1942, at 21. To assuage contractor's complaints that the existing law "left [proceedings] open too long," *id.* at 25, Section 801(c)(5) of the Revenue Act of 1942, Pub. L. 619, 56 Stat. 984, imposed a one-year limitation on the Government's power to initiate renegotiation proceedings. If the Government failed to give a contractor written notice that his profits might be excessive within one year after the contractor filed appropriate financial statements or within one year after the close of the fiscal

year within which the contract at issue was completed or terminated, the contractor's liability for excessive profits realized during the fiscal year covered by the financial statement was discharged. This one year statute of limitations was designed to terminate the Government's power to commence renegotiation proceedings if appropriate action was not accomplished within the prescribed period. The Congress was attempting to remedy a situation whereby contractors were put in an unsettled position for an indeterminate period of time.

The Renegotiation Act was amended again in 1943. One of the problems the amendment was intended to remedy was the concern over the unreasonable delays in administering renegotiation. The Committee on Naval Affairs reported that "it seems to be the impression of industry that renegotiation, as it is now administered, hangs as a Damocles sword which may descend upon contractors years after the completion of their contracts, in an effort to recover funds which will have long since been expended. This, of course, is quite inconsistent with the purposes and provisions of the Act." House Committee on Naval Affairs, Report on Renegotiation of War Contracts, 78th Cong., 1st Sess. (1943) at 10. Although the law did require the agency to commence renegotiation proceedings within one year after the contractor filed financial statements or within one year after the contract was completed or terminated, the Congress felt that these limitations periods were inequitable as the statute could be tolled when the Government initiated a renegotiation proceeding, without concluding it. Thus the forerunner of the current two year limitation on renegotiation imposed by section 105(c) of the 1951 Act was enacted in 1943, reflecting a Congressional desire to place strict limitations on the amount of time the Government could take in processing renegotiation cases once proceedings had begun. The Naval Committee recommended that once the renegotiation proceeding was instituted, the contractor's liability for excessive profits should be discharged if neither a renegotiation agreement nor a unilateral determination by the Secretary resulted within 14 months of the contractor's filing of a financial statement. House Committee on Naval Affairs, Report

on Renegotiation of War Contracts, 78th Cong., 1st Sess., (1943) at 11. As Congressman Disney remarked: "We want this business closed up." 89th Cong. Rec. 9928 (1943). Thus, the statutory limitations was added to the Act in 1943, providing:

> * * * If an agreement or order determining the amount of excessive profits is not made within one year following the commencement of the renegotiation proceeding, then upon the expiration of such one year all liabilities of the contractor or subcontractor for excessive profits with respect to which such proceeding was commenced shall thereupon be discharged, except that * * * such one-year period may be extended by mutual agreement. (Revenue Act of 1943, § 701(c), 58 Stat. 84.)

The statute of limitations in the 1951 Act imposes time limits upon the commencement and completion of renegotiation proceedings. No proceeding to determine excessive profits for any fiscal year may be commenced more than one year after the financial statement required from the contractor is filed with the Renegotiation Board and every proceeding must be completed by agreement or order within two years after commencement; otherwise all liabilities of the contractor for excessive profits during such year are discharged. In enacting this provision, Congress was aware of the prior amendment to the Act and the need to commence and conclude renegotiation proceedings within a reasonable period of time. The Congress did provide that the two year period could be extended by mutual agreement, but determined that if such an extension was not effected, then upon the expiration of the two year period, a contractor's liabilities were discharged.

The instant case represents a situation where the pendency of price redetermination proceedings made it logical, if not necessary, to suspend the renegotiation until the receipts and accrual allocable to the year under review could be accurately known. Instead of resenting the suspension as a "sword of Damocles" the contractor desired it. Nevertheless, the statute is sweeping and free of ambiguity. Unless plaintiff agreed to an extension, its 1957 renegotiation is dead.

Since the original two year period admittedly expired in June 1960, defendant must show that the limitations period

was extended by "mutual agreement." Neither the statute nor the applicable regulations explain what is necessary to constitute a "mutual agreement" within the meaning of the Act. There is no prescribed form in the 1951 Regulations which details the precise form of an agreement which would extend the statute of limitations. However, plaintiff and defendant did execute 15 written extension agreements between 1960 and 1971, all in virtually identical form. The extensions read as follows:

> IT IS HEREBY STIPULATED AND AGREED by and between the UNITED STATES OF AMERICA and NEWPORT NEWS SHIPBUILDING AND DRY DOCK COMPANY, a corporation organized and existing under the laws of the State of Virginia and having its principal office in the city of Newport News, Virginia (hereinafter referred to as "the Contractor"), that, in accordance with the provisions of Section 105(c) of the Renegotiation Act of 1951, the time within which a determination of the amount of excessive profits, if any, of the Contractor for its fiscal year ended ——— may be made by agreement or order pursuant to the Renegotiation Act of 1951, as amended, is hereby extended to and including ———————.

In fact, the written extension agreements are similar to the form set out in the Regulations for the 1943 Act for extending the one year statute of limitations in that Act. Counsel offer no explanation why this change in Regulation occurred, and we know of none except by surmise, but in view of what happened it is clear no real change in the procedure of agreeing on extensions was intended. The fact that plaintiff and defendant did execute written agreements using the familiar pre-established form does indicate a course of conduct which should not be overlooked. Defendant's contention that the 1963 correspondence was in effect a "mutual agreement" to extend the statute of limitations until the escalation proceedings were completed does not coincide with the parties actual interpretation of the 1963 correspondence as evidenced by their actions, that is, the timely signing and execution of eight written agreements designed to extend the statute of limitations. If defendant believed that the 1963 correspondence was a "mutual agreement" satisfying the statute, as it

now asserts, there would not have been any reason to execute the written extensions.

Plaintiff's undertaking "to execute any agreements necessary to extend the time * * *" as quoted, *supra*, must be read as meaning it would sign any agreement in the usual form timely proffered for signature. But even the commitment cannot be read as remaining open-ended after the Renegotiation Board knew the escalation claim had been paid in full, so there existed no further reason for delay.

Thus, on June 30, 1973, when the last of the parties' formally executed time extensions expired without Board issuance of a renegotiation order, the plaintiff's liability according to the statute was discharged. There is no indication that the parties made any mutual agreement to extend the statute of limitations beyond that date. Plaintiff did not, merely by requesting the Board in 1972 to reconsider its determination in light of this court's remand and ASBCA's subsequent decision, waive its right to rely on the statute of limitations. Plaintiff did not mislead the defendant so that defendant can rely on any estoppel theories. Defendant was as conscious as plaintiff of the fact that the renegotiation proceedings were governed by a statute of limitations, which expired on June 30, 1973. Moreover, plaintiff's June 15, 1972, letter specifically reminded the Board that the time for completion of the proceedings had been extended only until June 30, 1973. The Renegotiation Board's failure to execute the necessary extensions demands that plaintiff's liability be discharged. This is perhaps a harsh result, but one that is clearly required by the statute and intended by Congress in enacting the limitations provisions. Statutes of limitations have been enforced in many areas as a necessary instrument of judicial machinery, designed to encourage the speedy resolution of potentially time consuming cases.

While no criticism of the Government's able counsel is intended, for they must do the best they can, in an adversary context, with the cases they are given to defend, still some wry amusement may be derived from a comparison of defendant's litigation position herein with that which obtains when, *e.g.*, it is a question of the 30 day clause governing appeals by contractors from adverse contracting officer's de-

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cisions on contract claims. *See, Monroe M. Tapper & Assoc.* v. *United States*, 206 Ct. Cl. 446, 514 F. 2d 1003 (1975); *Maney Aircraft Parts, Inc.* v. *United States*, 202 Ct. Cl. 54, 479 F. 2d 1350 (1973), and previous decisions in the same cases. Defendant's enthusiasm for the role of the 30 day clause in forfeiting otherwise viable claims, and its repugnance to making exceptions in deserving cases, by exercise of a judge-created power of discretionary waiver of the bar, stand in stark contrast with its eager invocation herein of estoppel and other equitable concepts, to save its own claim from a similar forfeiture. We may notice the inconsistency of defendant's litigation positions, even if its own counsel do not.

The Board has not issued an agreement or order determining plaintiff's liability for excessive profits within the prescribed statute of limitations period. Therefore, plaintiff's liability for excessive profits for fiscal year 1957 is discharged. We grant plaintiff's motion for summary judgment on Count 1 of its petition and determine that the plaintiff's obligation to eliminate excessive profits received or accrued in its 1957 year has been discharged.

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527 F. 2d 1209

ERNIE J. JOHNSON v. THE UNITED STATES

[No. 88-74. Decided December 17, 1975. Plaintiff's motion for rehearing and to set aside judgment denied February 27, 1976.]

ON DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

Limitation of actions; accrual of cause of action; administrative remedy; NASA Inventions and Contributions Board.—On October 4, 1967 plaintiff was notified by NASA Administrator of rejection of his application to the NASA Inventions and Contributions Board for an award under 42 U.S.C. § 2457. On March 22, 1974 plaintiff filed suit in this court claiming defendant, without paying compensation, has used and continues to use his ideas, theories, exhibits, plans, etc. and seeking compensation therefor. Without deciding whether or not resort to the Board is mandatory, under the circumstances plaintiff's cause of action accrued when he was notified of rejection of his application for an award, at which time all of the events fixing the liability of the United States, if any, had taken place. Since this court's statute of limitations is 6 years, plaintiff's

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claim is time-barred. Defendant's motion for summary judgment is granted and the petition is dismissed.

Limitation of actions; accrual of cause of action; generally.

[1] Where pursuit of an administrative remedy is a prerequisite to suit, the statute of limitations begins to run from the final denial of the claim by the Board.

Limitation of Actions ⇐ 105(2)

Limitation of actions; accrual of cause of action; NASA Inventions and Contributions Board.

[2] Without deciding whether or not an application to the NASA Inventions and Contributions Board for an award under 42 U.S.C. § 2457 is mandatory, where a claimant does pursue that administrative remedy the bar on any suit in this court falls no later than 6 years after notification of final action on the claimant's application, since by that time all events fixing the liability of the United States, if any, have taken place entitling claimant to institute a court action. Under such circumstances, the claim is not a "continuing" one. This rationale applies whether the claim is characterized for a taking of private property, an action on an implied contract, or a suit based on the NASA statute and regulations relating to scientific and technical inventions and contributions.

Courts ⇐ 461(5)

Limitation of actions; accrual of cause of action; NASA Inventions and Contributions Board.

[3] Since Congress in Sec. 305 of the National Aeronautics and Space Act of 1958 expressly directed establishment of the Inventions and Contributions Board and authorized its use to evaluate applications for awards for scientific and technical contributions submitted to the agency, where a claimant utilizes the Board procedure it is fitting that he not be permitted to postpone judicial scrutiny of the agency's determination beyond the normal limitations period for filing suit, and, having chosen to seek relief through the Board, the claimant should not be allowed to act as if the Board did not exist.

Courts ⇐ 461(5)

Lester P. Schoene for plaintiff; *R. L. Witherspoon*, attorney of record.

Thomas J. Byrnes, with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Before DAVIS, SKELTON, and KUNZIG, *Judges*.

DAVIS, *Judge*, delivered the opinion of the court:

The claim is that (a) in July and August 1961 plaintiff made to the National Aeronautics and Space Administration (NASA) "suggestions, ideas and contributions relating to insulation of certain parts of space ships and vehicles; that he made and presented suggestions relating to wingless space craft, space ships and space vehicles, modules and space craft designed to successfully place men on the moon and return to earth"; (b) "the theories, exhibits, designs, models, materials, ideas and suggestions presented to the defendant had not previously been presented to the defendant by any one prior to the time this petitioner presented them to the defendant"; and (c) the Government, without paying compensation, has used and continues to use plaintiff's "ideas, theories, exhibits, plans, designs, contributions and materials." In April 1966 plaintiff submitted an application for compensation under 42 U.S.C. §§ 2457–58 to the NASA Inventions and Contributions Board; a hearing was held on May 8, 1967. In September 1967 upon recommendation of the Board, the Administrator of NASA rejected the claim for compensation and plaintiff was so notified on October 4, 1967. This suit, apparently brought under our general jurisdictional statute (28 U.S.C. § 1491), was filed on March 22, 1974. The Government has moved for summary judgment on the ground that the action is barred by the six-year statute of limitations (28 U.S.C. § 2501).[1]

Almost seven years elapsed between the denial by NASA of an award and the beginning of this litigation but plaintiff urges that his claim "first accrued" within the permissible six-year span. The contention is, on analogy to the principle that limitations on just compensation for a taking by flooding does not run until the full extent of the damages can be ascertained (*United States* v. *Dickinson*, 331 U.S. 745, 748–49 (1947)), that the claim here did not really mature until plaintiff could measure, in reasonable form, his entire loss. Even if we were to accept this comparison *arguendo*, it is clear that by the time plaintiff applied to the Inventions

[1] "Every claim of which the Court of Claims has jurisdiction shall be barred unless the petition thereon is filed within six years after such claim first accrues."

and Contributions Board, and had his hearing, he himself felt that he could reasonably gauge the scope of the award he expected. The situation had become stabilized enough so that he felt that he could ask for an administrative award; by the same token his judicial claim had sufficiently ripened so that it could be characterized as "first" accruing under 28 U.S.C. § 2501.[2]

Plaintiff's alternative argument is that this is a "continuing claim" on which he may be barred for periods prior to the six years antedating his filing of this suit but is not cut off from pursuing the claim for use during the six years before March 22, 1974. On this point there are two lines of authority in litigation between private parties. Applying California law, *Monolith Portland Midwest Co.* v. *Kaiser Aluminum & Chemical Corp.*, 407 F. 2d 288, 292–93 (C.A. 9, 1969), rejects the "continuing claim" theory on the ground that the core of a claim for misuse of trade secrets is not the adverse use of the claimant's "property" but the initial rupture of the confidential relationship between the parties. *Shatterproof Glass Corp.* v. *Guardian Glass Co.*, 322 F. Supp. 854, 869–70 (E.D. Mich. 1970), *aff'd on other grounds*, 462 F. 2d 1115 (C.A. 6), *cert. denied*, 409 U.S. 1039 (1972), follows *Monolith* without tying the rule to the law of any particular jurisdiction. *Underwater Storage, Inc.* v. *United States Rubber Co.*, 371 F. 2d 950 (C.A.D.C. 1966), *cert. denied*, 386 U.S. 911 (1967), took another position, accepting the "continuing claim" theory after full discussion [3]—as did, more summarily, *Siegerist* v. *Blaw-Knox Co.*, 414 F. 2d 375, 383 (C.A. 8, 1969), *Telex Corp.* v. *IBM Corp.*, 367 F. Supp. 258, 360 (N.D. Okla. 1973), *rev'd and modified on other grounds*, 510 F. 2d 894 (C.A. 10), *petition for cert. dismissed*, 423 U.S. 802 (1975), and *Koehring Co.* v. *National Automatic Tool Co.*, 257 F. Supp. 282, 293 (S.D. Ind. 1966), *aff'd per curiam*, 385 F. 2d 414 (C.A. 7, 1967).

[2] We discuss this theory on the assumption that resort to the Board was not a prerequisite to suit. If it was, the claim would have arisen no later than early October 1967 when plaintiff was informed of the administrative denial. *Friedman* v. *United States*, 159 Ct. Cl. 1, 8–13, 310 F. 2d 381, 385–88 (1962), *cert. denied*, 373 U.S. 932 (1963).

[3] The *Monolith Portland* opinion distinguishes *Underwater Storage* as applying District of Columbia law, but the latter is written in general terms and can be read as applying general or federal law.

We are not put to a choice between these differing trends, nor need we try to harmonize them. In our view this case turns on the cardinal fact that the plaintiff sought relief from the NASA Inventions and Contributions Board and was denied all recovery more than six years before he began the suit. Section 305(f) of the National Aeronautics and Space Act of 1958, 42 U.S.C. § 2457(f), directed the NASA Administrator to establish an Inventions and Contributions Board. In turn, Section 306, 42 U.S.C. § 2458, authorized the Administrator, "upon his own initiative or upon application of any person, to make a monetary award, in such amount and upon such terms as he shall determine to be warranted, to any person * * * for any scientific or technical contribution to the Administration which is determined by the Administrator to have significant value in the conduct of aeronautical and space activities. Each application made for any such award shall be referred to the Inventions and Contributions Board established under [Section 2457 of Title 42, *supra*]. Such Board shall accord to each such applicant an opportunity for hearing upon such application, and shall transmit to the Administrator its recommendation as to the terms of the award, if any, to be made to such applicant for such contribution." The statute then goes on to spell out the general factors which the Administrator shall take into account in determining the terms and conditions of any award, to provide for a release by the applicant of all claims to other compensation in return for an award, and to defer the effective date of an award exceeding $100,000 until the expiration of thirty calendar days of regular session of the Congress after receipt by the appropriate committees of the Congress of a "full and complete report" from the Administrator "concerning the amount and terms of, and the basis for, such proposed award." NASA has filled out these statutory provisions with regulations detailing the form of application and prescribing the Board's procedure. 14 C.F.R. §§ 1240.100–1240.106.

Without deciding whether or not the administrative remedy through this Board is mandatory,[4] we hold that,

[4] As already indicated (fn. 2, *supra*), it is thoroughly settled that, if the administrative remedy is a prerequisite to suit, limitations begins to run from the Board's determination. *See also Burich* v. *United States*, 177 Ct. Cl. 139, 143, 366 F. 2d 984, 986–87 (1966), *cert. denied*, 389 U.S. 885 (1967).

where a claimant does pursue that remedy, the bar on any suit in this court falls no later than six years after notification of final action on his application. By the time his request for agency relief is thus denied, he knows that (a) in his own mind at least, he has a claim upon the Government for compensation for the use of his ideas, (b) he can estimate the amount of the award to which he considers himself entitled, (c) the Government has formally and definitively rejected his claim (or considers it not as valuable as he does), and (d) by formally turning down his claim (in whole or in part), NASA deems itself free in ordinary course to use "his" ideas without making the payment he seeks. These are all the events fixing the liability of the United States, if there is any, and entitling the claimant to institute an action. *Cf. Oceanic S.S. Co.* v. *United States*, 165 Ct. Cl. 217, 225 (1964); *Kirby* v. *United States*, 201 Ct. Cl. 527, 532–33, 536 (1973), *cert. denied*, 417 U.S. 919 (1974); *Boardman* v. *United States*, 180 Ct. Cl. 264, 268–69, 376 F. 2d 895, 897–98 (1967), *cert. denied*, 390 U.S. 953 (1968); *Japanese War Notes Claimants Ass'n* v. *United States*, 178 Ct. Cl. 630, 632, 634, 373 F. 2d 356, 358, 358–59, *cert. denied*, 389 U.S. 971 (1967). This is equally true whether the claim be characterized as for a taking of private property, an action on an implied contract (*cf. Padbloc Co.* v. *United States*, 161 Ct. Cl. 369 (1963)), or a suit based on the NASA statute and regulations relating to scientific and technical inventions and contributions.

In the circumstances, to hold that, after choosing to follow through on the agency's proceeding, the claimant can delay suit for more than the statutory six years from the agency decision would be to permit an unnecessary and unjustified, even though only partial, prolongation of the limitations period at the plaintiff's own choice. *Cf. Feldman* v. *United States*, 149 Ct. Cl. 22, 32, 181 F. Supp. 393, 400 (1960); *Friedman* v. *United States*, 159 Ct. Cl. 1, 9–11, 310 F. 2d 381, 386–87 (1962), *cert. denied*, 373 U.S. 932 (1963). And since Congress expressly directed the establishment of the Inventions and Contributions Board and authorized its use to evaluate claims like plaintiff's, it is fitting that, where a claimant utilizes the Board procedure, he not be permitted

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to postpone judicial scrutiny of the agency's determination beyond the normal span. The claimant, having chosen to seek relief through the Board, should not be allowed to act as if the Board did not exist. Whatever other consequences it may or may not have in court, a Board's decision purporting to pass on the whole of the applicant's claim should at least spring and ready the entire claim for judicial consideration. When the demand is against a private party, the owner of the alleged trade secret may not learn the fact or extent of the initial appropriation until after the original limitations period (*i.e.* starting from the appropriation). But for those who pursue NASA's administrative remedy, the final determination normally gives them all the information they need (if they do not already have it), plus an authoritative official notification that the agency will not pay the compensation sought. There is no adequate reason to wait longer or to consider the claim a "continuing" one which could be brought many years, even decades, after the Board's determination.

For these reasons, we grant defendant's motion for summary judgment on the basis that the suit was filed too late, and dismiss the petition.

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527 F. 2d 1176

WILLIAM CROWLEY, JAMES C. FALCONER, JOHN H. MILLER, DONALD P. SEVERANCE AND HAROLD C. STORJOHANN v. THE UNITED STATES

[No. 93–72. Decided December 17, 1975]

ON PLAINTIFFS' AND DEFENDANT'S MOTIONS FOR SUMMARY JUDGMENT

Civilian pay; termination of temporary promotions; scope of Veterans' Preference Act; retention preference; adverse personnel action.—Plaintiffs, employees of the Department of the Navy at the Portsmouth Naval Shipyard, Portsmouth, New Hampshire, and veterans' preference eligibles, each received, between November 1967 and March 1968, at least one temporary promotion to the next higher grade position. The temporary promotions were subsequently terminated and, after unsuccessful appeals to the Civil Service

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Commission Board of Appeals and Review, each plaintiff was returned to his former permanent position. Plaintiffs contend that, at the time they were respectively demoted, competing non-veteran employees, or employees with fewer job retention rights, who had received similar but subsequent temporary promotions, were either retained or made permanent in the higher grade positions, in violation of plaintiffs' rights under the Veterans' Preference Act and implementing Civil Service Commission regulations. Plaintiffs seek back pay and permanent reinstatement to the higher grade positions. The factual situation underlying each plaintiff's claim is set forth in the opinion. It is *held* (1) that the Veterans' Preference Act and applicable regulations guarantee veteran temporary promotees neither permanent promotions to nor retention rights in higher level Government positions, and (2) that while the termination of the temporary promotions did, at the time plaintiffs were respectively promoted, constitute an "adverse action" within the meaning of 5 U.S.C. § 7512 and 5 C.F.R. Part 752, plaintiffs have failed to establish that such actions were arbitrary, capricious or otherwise not "for such cause as will promote the efficiency of the service," as that standard has been construed by this and other courts. Plaintiffs' motion for summary judgment is denied, defendant's cross-motion is granted, and the petition is dismissed.

Civilian pay; Veterans' Preference Act; scope of Act.

[1] The granting of preference to veterans in certain aspects of public employment is an established principle in both State and Federal practice. The Veterans' Preference Act of 1944, 58 Stat. 387, reflects Congress' will to encourage and reward military service to the Nation, but the rights and benefits thereunder are not limitless. Its provisions are necessarily specific and for a claimant to benefit therefrom he must show himself to be clearly within the intended ambit of those provisions.

Officers ⟸ 10

Civilian pay; Veterans' Preference Act; promotions.

[2] With certain exceptions set forth in Secs. 4 and 5 of the Veterans' Preference Act of 1944, neither the Act nor the Civil Service regulations promulgated thereunder accord veterans preferential treatment in promotions.

Officers ⟸ 10

Civilian pay; promotions; temporary promotions; Veterans' Preference Act.

[3] The Civil Service regulations promulgated under the Veterans' Preference Act of 1944 and the Federal Personnel Manual implementing and explaining them do not treat temporary promotions of Government employees as an automatic preamble to permanent promotions, without regard to the otherwise applicable requirements of the Federal Merit Promotion program. Service by a Government employee in an acting capacity does not entitle him to permanently occupy that position nor to receive the salary incident thereto, as

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his rights and salary are based solely on the position to which he has been officially appointed.

Officers ⟸ 10

Civilian pay; promotions; rights to.

[4] A Government employee possesses no constitutional, inherent or vested right to a promotion.

Constitutional Law ⟸ 102(1)

Civilian pay; promotions; selection for promotion; agency discretion.

[5] Promotion and non-promotion of employees within a department or agency of the Government is a matter of supervisory discretion not ordinarily subject to judicial review. Substitution of the court's judgment as to who should receive permanent promotions would constitute an unwarranted judicial interference with discretionary executive action.

United States ⟸ 36

Civilian pay; presumptions; official actions of Government officials; presumption of regularity.

[6] In reviewing adverse actions against Federal employees, this court requires almost irrefragable proof to overcome the general presumption that the Government discharged its duties in good faith and in a legal and proper manner.

United States ⟸ 36

Regulations of Executive Department; retroactivity of.

[7] In interpreting the adverse actions regulations (5 C.F.R. § 752.103(b)(5)) in the instant and similar cases, the Civil Service Commission Board of Appeals and Review has consistently avoided retroactive application of the amendments thereto, and has held controlling those regulations existing at the time respective employees initially received their temporary promotions. The court adopts this policy.

United States ⟸ 36

Civilian pay; promotions; temporary promotions; applicability of reduction-in-force procedures; retention preference.

[8] The provisions of 5 U.S.C. Pt. 35 and the reduction-in-force regulations promulgated thereunder, 5 C.F.R. § 351.201 et seq., afford veterans' preference eligibles, who are returned from temporary promotions to their lower permanent positions, no entitlement to preference over non-veterans who permanently occupy the higher grade positions. The reduction-in-force regulations group employees *by tenure* and limit the reach of veterans' preference to competing employees of the same group.

Officers ⟸ 10

Civilian pay; reduction in force; retention preference; temporary promotee.

[9] Were management required in every instance to use reduction-

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nent grade, the result would be to obviate the utility of the temporary promotion as a device for meeting short-term needs. This was not the intent of the Veterans' Preference Act.

Officers ⇐ 10

Civilian pay; adverse personnel action; what constitutes.

[10] Under the law in effect at the time of the temporary promotions, the return of temporary promotees to their lower permanent positions constituted an adverse action and, hence, must have been "for such cause as will promote the efficiency of the service."

Officers ⇐ 11.7

Civilian pay; promotions; temporary promotions; retention preference.

[11] The Government's original purpose in applying Sec. 14 (adverse action) rather than Sec. 12 (reduction in force) of the Veterans' Preference Act to the termination of temporary promotions was two-fold: (1) to afford veteran temporary promotees certain procedural safeguards against purely arbitrary agency action, and (2) at the same time, to avoid the result of permitting such veterans, whose status and tenure are not changed after promotion, upon a decrease in workload, to automatically displace all nonveterans who had been occupying the higher grade positions on a permanent basis.

Officers ⇐ 10

Civilian pay; promotions; temporary promotions; return to permanent position.

[12] The so-called rule in *In re Kenneth E. Thompson*, Board of Contract Appeals Decisions, March 18, 1969, that employees last *qualified* (by inclusion on a competitive promotion register, i.e., not those employees last *temporarily promoted*) must be first demoted when the temporary workload decreases, comports with the policy and preferences underlying the Federal Merit Promotion program, while preserving that measure of discretion (e.g., as between competing temporary promotees selected from the *same* register) essential to the utility of the temporary promotion device.

United States ⇐ 36

Civilian pay; Court of Claims jurisdiction; administrative or executive decisions; review of by court.

[13] It is not this court's function to substitute its judgment for that of the employing agency or the Civil Service Commission; rather, the court reviews the case to determine whether their action was reasonable in light of all the evidence.

United States ⇐ 36

Civilian pay; adverse personnel action; what constitutes.

[14] Where each plaintiff was informed in advance that his promotion was to be temporary in nature, that it was intended solely to meet a special and temporary need, and that he would be re-

Opinion of the Court

turned to his former permanent position upon expiration of that need, or whenever such termination was otherwise considered to be in the best interest of the service, and where, upon termination, each promotee was informed that the termination was not intended as a reflection on his capability or performance, and where he was not permanently precluded from actively competing for subsequent permanent promotions, defendant's actions were not arbitrary, capricious, contrary to applicable statutes and regulations, or other than for such cause as would promote the efficiency of the service. Standing alone, a showing by plaintiffs that other competing employees, who had received temporary or permanent promotions subsequent to plaintiffs, were retained at the higher level positions when plaintiffs' temporary promotions were terminated, does not entitle plaintiffs to back pay and permanent reinstatement to the higher level positions.

United States ⇐ 36

Edward L. Merrigan, attorney of record, for plaintiffs. *Smathers, Merrigan & Herlong*, of counsel.

LeRoy Southmayd, Jr., with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Before COWEN, *Chief Judge*, DURFEE, *Senior Judge*, and SKELTON, *Judge*.

COWEN, *Chief Judge*, delivered the opinion of the court:

This case concerns the applicability of the Veterans' Preference Act to the termination of the temporary promotions of veterans' preference eligibles permanently employed by the Federal Government. Plaintiffs William Crowley, James Falconer, John H. Miller, Donald P. Severance and Harold C. Storjohann, employees of the Department of the Navy at the Portsmouth Naval Shipyard (Shipyard), Portsmouth, New Hampshire, each received, between December 1967 and March 1968, at least one temporary promotion to the next higher grade position. In each case, the respective temporary promotions were subsequently terminated and, after unsuccessful appeals to the Civil Service Commission's (CSC) Board of Appeals and Review (BAR), each plaintiff was returned to his former permanent position. Plaintiffs contend that when they were thus demoted, competing nonveteran employees, who had received similar temporary promotions subsequent to plaintiffs', were either retained or

made permanent in the higher grade positions, in violation of plaintiffs' rights under the Veterans' Preference Act and the Civil Service Commission regulations promulgated thereunder. Plaintiffs, who have combined their cases inasmuch as they present substantially the same basic issues, seek back pay and permanent reinstatement to the higher level positions.

The three principal questions presented by the parties' cross-motions for summary judgment are whether plaintiffs' rights under the Veterans' Preference Act were violated or abridged by (1) defendant's promotion of competing non-veterans (or employees with fewer "job retention rights") over plaintiffs; (2) defendant's retention of non-veteran temporary promotees over plaintiffs; or (3) defendant's termination of plaintiffs' temporary promotions. As to the first two questions, we have concluded that the Act and applicable regulations guarantee veteran temporary promotees neither permanent promotions to nor retention rights in higher level Government positions. While the termination of the temporary promotions did, at the time plaintiffs were respectively promoted, constitute an "adverse action" within the meaning of 5 U.S.C. § 7512 and 5 C.F.R. Pt. 752, we hold that plaintiffs have failed to establish that such actions were arbitrary, capricious or otherwise not "for such cause as will promote the efficiency of the service," as that standard has been construed by this and other courts. Accordingly, we deny plaintiffs' motion for summary judgment and grant defendant's cross-motion.

The facts essential to our decision are not in dispute. However, inasmuch as the underlying circumstances differ somewhat from one claim to another, we set forth the facts of each plaintiff's claim individually.

1. *Plaintiff William C. Crowley*

Plaintiff Crowley was temporarily promoted on March 10, 1968, from the position of Production Shop Planner Pipefitter to that of Foreman (Leadingman) Pipefitter. Prior thereto, on February 23, 1968, he signed a standard form proposed temporary promotion agreement, stating thereon: "I understand and agree to the conditions of my proposed temporary promotion." The agreement, substantially identi-

cal to those signed by each of the other plaintiffs set forth the purpose, conditions and expected duration of the temporary promotion as follows:

> a. *Position:* Foreman Pipefitter—Shop 56
> b. *Temporary—Not to Exceed:* NTE 30 days. This temporary promotion is expected to continue for the period shown above. It may, however, be terminated earlier whenever the temporary condition for which it was made no longer exists, or whenever, for other reasons, it is determined to be in the best interest of the Shipyard to do so.
> c. *Why this Promotion is Temporary:* To replace Mr. Philip J. Theberge who is on extended sick leave.
> d. *Termination of Temporary Promotion:* You will return to your present position and pay step whenever the basis for your temporary promotion no longer exists, or whenever other reasons occur which warrant terminating your temporary promotion. Your promotion may be terminated at any time during the first 90 days. If it continues for more than 90 days, you will be notified of the proposed termination, and the reason for it, at least 30 days before its effective date.

After the permanent foreman's return, several extensions of plaintiff Crowley's temporary promotion were made in order "[t]o provide supervision for personnel borrowed from other activities during a peak workload" (March 29, 1968, NTE May 25, 1968), and "* * * also to provide additional supervision coverage from the SSB(n)619" (May 15, 1968, NTE July 13, 1968; NTE August 24, 1968). In each instance, the reasons for the temporary promotion, and the conditions under which it was being offered, were clearly set forth in a standard form memorandum agreement signed by plaintiff.

On November 4, 1968, plaintiff Crowley was issued an advance notice of termination for the stated reason that "personnel borrowed from other activities are being returned to home yards and there is no longer need for additional supervisory coverage on SSB(n)619." The notice also stated that "although this termination is technically classified as an 'adverse action,' it is not in any way a reflection on your performance." Plaintiff was returned to his regular permanent position on November 10, 1968.

Plaintiff Crowley appealed his termination on the ground, among other things, that at the time thereof, defendant retained in the higher level position the following competing non-veteran employees who, in several cases, had allegedly been temporarily promoted subsequent to his temporary promotion:

Employee[1]	*Retention Status*	*Date of Temporary Promotion*
Walter M. Hellen	1B	2/22/70
Wylie E. Brewster	1B	4/7/68
Elwood D. Cook	1B	3/10/68
Plaintiff Crowley	1A	3/10/68
Charles R. Morris	1B	4/2/67
George A. Black	1B	4/2/67
Robert E. Grodan	1B	4/2/67

[1] This list is the subject of some dispute between the parties. In *Defendant's Reply to Plaintiffs' Argument Set Forth in Plaintiffs' Motion for Leave to File Exhibits, Etc.* (*Defendant's Reply*), at 2, filed Sept. 8, 1975, defendant alleges, for example, that one *Elwood D. Cook* had previously held the permanent position of Foreman (Leadingman) Pipefitter from Aug. 27, 1961 to March 31, 1963, and the temporary Leadingman position from Feb. 16, 1964 to April 26, 1964. Under these circumstances, according to defendant, the Federal Personnel Manual (FPM), Ch. 335 (1968), did not require that Mr. Cook compete for repromotion to the position previously held on a permanent basis. He was, instead, merely reinstated to that position by conversion from CSC Certificate 118 as a repromotion candidate. Plaintiff disputes this assertion, claiming that Cook's earlier service entitled him only to "consideration," not absolute preference. *Plaintiff's Response to Document Filed by Government on September 8, 1975 By Leave of Court* (*Plaintiffs' Response*), at 5, filed Oct. 3, 1975.

Also in its *Reply*, at 2–3, defendant alleges that, although *Wylie Brewster* was temporarily promoted on April 7, 1968, that promotion, after several extensions, was terminated on Aug. 10, 1968. On Aug. 11, 1968, Mr. Brewster was temporarily promoted to the position of Foreman *Refrigeration and Air-Conditioning Mechanic*, which promotion was converted to permanent on Sept. 21, 1969. This position, according to defendant, is neither in the same competitive area nor at the same retention level as that of plaintiff Crowley.

Finally, defendant alleges that *Walter M. Hellen* in fact declined the temporary promotion which plaintiff lists as effective Feb. 22, 1970. *Defendant's Reply*, at 3. Instead, according to defendant, when plaintiff Crowley was returned for the second and final time, on March 8, 1970, to his lower permanent grade, Mr. Hellen, too, was serving as a Pipefitter. Subsequently, on June 28, 1970, Mr. Hellen was temporarily promoted to Foreman, and then returned to Pipefitter on Sept. 20, 1970. A second temporary promotion, not made until November 14, 1971, was ultimately converted to permanent on February 9, 1972. Thus, defendant argues, even assuming, *arguendo*, that reduction-in-force procedures were applicable in February 1970, when plaintiff Crowley received his second notice of termination neither Mr. Brewster nor Mr. Hellen would have been included in the appropriate retention register, since neither employee was serving as a Foreman Pipefitter at that time.

In a decison dated July 10, 1969, the CSC's Boston Regional Office found that plaintiff Crowley's return to the

lower grade was warranted and was for such cause as would promote the efficiency of the Service. On November 25, 1969, however, the BAR reversed this decision, finding that plaintiff "was not returned to his former position as a result of the termination of the terms of his agreement but [the return] was also due to the making of additional permanent promotions in the meantime." Plaintiff was thereupon restored to the Foreman (Leadingman) Pipefitter position retroactively to November 10, 1968.

On February 2, 1970, plaintiff Crowley received a second notice of termination, this time pursuant to a reduction in force at the Shipyard in the Foreman (Leadingman) Pipefitter level. Plaintiff was thereupon returned to his permanent position on March 8, 1970. Upon appeal, the CSC's Boston Regional Office, in a decision dated April 8, 1970, reversed the Shipyard's action for reasons similar to those stated by the BAR in its decision concerning plaintiff's termination.[2] On August 21, 1970, however, the BAR reversed the Regional Office decision, and held that the agency action was "for such cause as will promote the efficiency of the service."

2. *Plaintiff James Falconer*

Plaintiff Falconer was temporarily promoted on December 31, 1967,[3] from the position of Foreman (Leadingman) Pipefitter to that of General Foreman, Pipefitter, as a result of a Navy competitive promotion examination for the higher level position. Prior thereto, on December 26, 1967, he signed a standard form memorandum agreement similar to those signed by the other plaintiffs, stating thereon that "I understand and agree to the conditions of my proposed temporary promotion as explained above." The reason for the temporary promotion, as explained therein, was "because of the increased emphasis on third-shift work and to coordinate the efforts of the four Foremen on that shift and their employ-

[2] The decision of the Regional Office was also, and primarily, based on the BAR decision of Feb. 2, 1970, in the case of *Kenneth E. Thompson*, which the Office considered controlling in plaintiff Crowley's case. See our discussion of the *Thompson* case in Part IV of this opinion, *infra*.

[3] Plaintiff Falconer appears to have received an earlier temporary promotion to General Foreman on July 16, 1967, which was subsequently terminated on November 19, 1967, without appeal. *Plaintiff's Response*, at 16; *Defendant's Reply*, at 6.

ees." After several extensions for substantially the same reasons as the initial temporary promotion, plaintiff Falconer's promotion was terminated, effective November 3, 1968, and he was returned to his former permanent position. Plaintiff Falconer appealed the termination primarily on the ground that, at the time thereof, defendant retained and later permanently promoted a Mr. Trafton T. Sprowl, another veteran employee who had been selected for a temporary promotion to the General Foreman position from the same competitive promotion register, but who had fewer years of service than plaintiff.[4]

The Regional Office, in a decision dated July 10, 1969, sustained defendant's action. On November 28, 1969, the BAR affirmed the Office's decision on the grounds that (1) when plaintiff received his temporary promotion on December 31, 1967, Mr. Sprowl had already been serving in the higher level position on a temporary basis since February 12, 1967, which position was thereafter converted to permanent on February 25, 1968; (2) the increased work emphasis was tapering off so that a need for additional personnel as General Foremen on a temporary basis had ceased; and (3) plaintiff's termination was properly effected in accordance with defendant's established procedure of selecting first for demotion that person who was last (i.e., most recently) temporarily promoted.

3. *Plaintiff John H. Miller*

Plaintiff Miller, after selection from an established promotion register, was temporarily promoted on April 14, 1968, from the position of Pipefitter to that of Foreman (Leadingman) Pipefitter. Prior thereto, on April 5, 1968, he signed a standard form memorandum agreement, similar to those signed by the other plaintiffs, which stated that the purpose of the temporary promotion was "[t]o replace Raymond

[4] In addition to Mr. Sprowl, plaintiffs also cite Mr. Andette and Mr. Sullivan as non-veteran personnel who were retained at the time of plaintiff Falconer's demotion. According to defendant, however, Mr. Andette was permanently promoted to the General Foreman position on January 29, 1967, 5 months before plaintiff's first temporary promotion and 11 months before his second (on December 31, 1967). Similarly, according to defendant, Mr. Sullivan was permanently promoted to General Foreman on March 26, 1967, 3 months before plaintiff's temporary promotion, and 9 months before his second temporary promotion. *Defendant's Reply*, at 6.

Plourde, regular Foreman Pipefitter, who is on extended sick leave." After an extension, NTE September 5, 1968, for the same purpose as the initial promotion, plaintiff received a notice of proposed termination for the stated reason that Mr. Plourde had retired and a permanent replacement had been selected from the register of eligibles resulting from a Navy Merit Promotion examination. Plaintiff's temporary promotion was thereupon terminated, effective November 3, 1968.

Plaintiff appealed the termination on the grounds that, at the time thereof, defendant retained in the higher level position certain competing non-veteran employees who, in several cases, had allegedly been temporarily promoted subsequent to plaintiff.[5] The Regional Office, in a decision dated October 10, 1969, sustained defendant's action. On January 22, 1970, the BAR affirmed the Office's decision, stating that "[w]hen the sole reason for the temporary promotion ceased to exist (Mr. Plourde's absence * * * because of sickness) by virtue of his [i.e., Mr. Plourde's] retirement, it is obvious that the express condition necessitating the temporary promotion was fulfilled."

4. *Plaintiff Donald P. Severance*

Plaintiff Severance was temporarily promoted on December 17, 1967, from the position of Pipefitter to that of Foreman (Leadingman) Pipefitter. He served in the higher level position until October 5, 1968, under three consecutive extensions, for each of which he signed the standard form memorandum agreement setting forth the respective reasons for the temporary promotions as (1) "to carry out the supervisory requirements on the second shift for the workload on the SS(n)597" (December 8, 1967); (2) "[c]ontinued shift emphasis on the AGSS555, SS(n) 597, and SS(N)646" (January 8, 1968); and (3) "[b]ecause of continued emphasis" on the above-listed and other specified projects (March 8, 1968). Thereafter, plaintiff's temporary promotion was terminated, effective October 6, 1968, and he was returned

[5] Plaintiff Miller's contentions regarding competing non-veterans, like plaintiff Crowley's, primarily focus on Messrs. Brewster, Cook, Morris, and Hellen. As to the parties' factual dispute over the status of these individuals, see note 1, *supra*, and accompanying text.

to his former permanent position. Plaintiff thereupon appealed the termination on the ground that, at the time thereof, defendant retained in the higher level position certain competing non-veteran employees who, in several cases, had allegedly been temporarily promoted subsequent to plaintiff.[6] The Regional Office, in a decision dated October 10, 1969, sustained defendant's action. On March 2, 1970, the BAR affirmed this decision.

5. *Plaintiff Harold C. Storjohann*

Plaintiff Storjohann was temporarily promoted on September 14, 1967, from the position of Machinist (Marine) to that of Foreman Machinist (Marine), in order "[t]o replace," according to the standard form agreement, "the Foreman Machinist (Marine) who will be temporarily promoted to Foreman Machinist (Marine) I." After two extensions for the purposes of providing "supervisory coverage of SSB(N) 619 refueling operation" (April 1, 1968) and "[t]o accomplish a temporary heavy workload as a result of work on" specified projects (July 18, 1968), the temporary promotion was terminated pursuant to a reduction in force at the Foreman Machinist level, and plaintiff was returned to his former permanent position, effective July 19, 1969.

Plaintiff appealed the termination on the ground that at the time thereof, defendant retained in the higher level position certain competing temporarily promoted employees, with no or fewer veterans' preference retention credits, who, in several cases, had allegedly been temporarily promoted subsequent to plaintiff.[7] The Regional Office, in a decision dated January 16, 1970, sustained defendant's action. On April 7, 1970, the BAR affirmed the Office's decision on the grounds

[6] Plaintiff Severance's contentions regarding competing non-veterans, like plaintiff Crowley's and plaintiff Miller's, primarily focus on Messrs. Brewster, Cook, Morris, Black and Hellen. As to the parties' factual dispute over the status of these individuals, see note 1 *supra*, and accompanying text.

[7] Plaintiff Storjohann's contentions regarding competing temporarily promoted non-veterans primarily focus on Messrs. Leo Redden, Leon R. Goodwin, David F. Vachon, Jean Beauchemin, and Donald Corporan. Mr. Redden and Mr. Goodwin, according to plaintiff's own submissions, however, received their temporary promotions subsequent to plaintiff's *initial* temporary promotion (September 14, 1967), which was subsequently terminated without appeal, effective February 25, 1968. When plaintiff received his *second* temporary promotion on April 7, 1968, Mr. Redden and Mr. Goodwin had been serving continuously in the higher level positions for 4 months and 5 months, respectively. Mr. Redden's temporary promotion was converted to permanent

that (1) the increased workload which necessitated plaintiff's temporary promotion had ceased; and (2) the CSC regulations mandate the return of all temporary promotees to their former permanent positions before any competing permanent employees may be released (i.e., displaced by higher-standing permanent employees) pursuant to a reduction in force.

I

The Scope of the Veterans' Preference Act

There can be no dispute that the granting of preference to veterans in certain aspects of public employment is an established principle in both State and Federal practice. *See, e.g., Fredrick* v. *United States*, 205 Ct. Cl. 791, 799, 507 F. 2d 1264, 1268 (1974). *White* v. *Gates*, 253 F. 2d 868, 869 (D.C. Cir.), *cert. denied*, 356 U.S. 973 (1958); *Feinerman* v. *Jones*, 356 F. Supp. 252, 259 (M.D. Pa. 1973); *Koelfgen* v. *Jackson*, 355 F. Supp. 243, 251–52 (D. Minn. 1972), *aff'd mem.*, 410 U.S. 976 (1973). Thus, as plaintiffs correctly point out, the Veterans' Preference Act of 1944, 58 Stat. 387 (codified in scattered sections of Title 5, United States Code), among other things, accords veterans special point and service credit preferences in civil service entrance and other examinations, 5 U.S.C. § 3311; waives age and physical requirements, wherever possible, for veterans seeking Government appointments and promotions, *id.* §§ 3312, 3363; affords veterans' preference eligibles special procedural and substantive safeguards in removal and other adverse action proceedings, *id.* § 7512; and grants such eligibles certain

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on December 1, 1968; Mr. Goodwin was permanently promoted on April 21, 1968.

In addition, plaintiff alleges that he has 18 years' longer service than Mr. Redden, and 21 years' longer service than Mr. Vachon. Defendant counters, however, that from 1938 to 1959, plaintiff in fact served in the regular Navy, another career from which he already receives retirement benefits, and that his tenure in the civil service began only in June of 1959, whereas Mr. Redden's service credits actually date back to 1957, and Mr. Vachon's to 1960. Defendant also argues that none of the above-listed employees was temporarily promoted from a competitive promotion register established *after* the one on which plaintiff first qualified (i.e., that established in August 1967, and in effect through November 1969). Thus, while Mr. Vachon was temporarily promoted after plaintiff, *both* promotions were from the *same* register. In light of our reading of the *Thompson* decision, among other reasons, we find this last argument dispositive of most of the factual questions here presented. *See* Part IV of this opinion, *infra*.

preferential rights in reduction-in-force situations. *Id.* § 3501 *et seq.*

That the Veterans' Preference Act reflects Congress' will, as stated in *Johnson* v. *Robison*, 415 U.S. 361, 382 (1974), to encourage and reward military service to the Nation, does not, however, render limitless the rights and benefits which the Act furnishes. Nor does the Act, as plaintiffs would apparently have us believe, cloak veterans with any "penumbral rights;" its provisions are necessarily specific, and for plaintiffs to benefit therefrom they must show themselves to be clearly within the intended ambit of those provisions. We noted as much in *Powers* v. *United States*, 169 Ct. Cl. 626, 630 (1965), where, in upholding the Government's removal without hearing of a veteran career-conditional employee serving a one-year probationary period, we stated:

> This court is unable to accept the assertion of plaintiff that, on the basis of a general policy of the Government (and without regard to specific statutes and regulations), a veteran is entitled to special treatment, including a hearing. Since plaintiff has not shown any failure of the Government to comply with any applicable statute or regulation, we must conclude that the removal of plaintiff involved no violation of his procedural rights.

Although the briefs and submissions of both parties have exhaustively detailed the facts and circumstances underlying plaintiffs' claims, they have been of considerably less assistance in resolving the legal issues which we are called upon to decide. Nevertheless, three possible questions would appear to be presented by plaintiffs' case: (1) *the promotion question:* whether defendant's failure to permanently promote plaintiffs, before or about the time it permanently promoted certain non-veterans, violated the Veterans' Preference Act and the regulations, or was otherwise arbitrary and capricious; (2) *the retention preference question:* whether defendant's failure to retain plaintiffs in their temporary positions, while retaining others with fewer or no retention preference rights, violated the Act and regulations, or was otherwise arbitrary and capricious; and (3) *the adverse action question:* whether defendant's terminations of the temporary promotions of plaintiffs, insofar as they constituted "adverse actions" within the meaning of 5 U.S.C.

§ 7512 and 5 C.F.R. Pt. 752, were proper and warranted as being "for such cause as will promote the efficiency of the service." The opinion which follows will address each of these questions in the order listed.

II

The Promotion Question

In setting forth the circumstances underlying their respective claims, plaintiffs describe repeated instances wherein defendant passed over one or another of the plaintiffs in selecting individuals for promotion. Addressing plaintiff Falconer's claim, for example, plaintiffs state that "although there have been numerous openings in the position of General Foreman Pipefitter during this period, defendant has arbitrarily and capriciously selected other competing employees possessed of either no Veterans' Preference rights or less [sic] Veterans' Preference rights than plaintiff to fill same." *Plaintiffs' Motion for Summary Judgment*, at 7. In support of this assertion, plaintiffs offer a chronology of such promotions to the General Foreman position extending from August 1969 to date. Although plaintiffs nowhere expressly state the legal basis for such assertions, presumably they derive from plaintiffs' belief that the Veterans' Preference Act and applicable CSC regulations somehow grant veterans employed by the Federal Government unconditional preference in promotions. We cannot agree.

When the Veterans' Preference Act was passed, it was explained to Congress that it provided a preference both in *appointment* to and *retention* in Federal positions. *See Hilton* v. *Sullivan*, 334 U.S. 323, 338 n. 14 (1948). With the sole exceptions of additional credits for military service provided examinees by Section 4 of the Act, 5 U.S.C. § 3311, and the waiver under Section 5 of certain physical requirements for promotion, 5 U.S.C. § 3363, neither the Act nor the CSC regulations promulgated thereunder accord veterans preferential treatment in promotions. *See Pulley* v. *TVA*, 368 F. Supp. 90, 93 (M.D. Tenn. 1973).

Nor do the regulations, or the FPM implementing and explaining them, treat temporary promotions as an automatic

preamble to permanent promotion without regard to the otherwise applicable requirements of the Federal Merit Promotion program. On the contrary, 5 C.F.R. § 335.103 expressly provides that "an agency may make promotions . . . only to positions for which the agency has adopted and is administering a program designed to insure a systematic means of selection for promotion according to merit." In addition, the FPM, at Ch. 335, Subch. 1-8, states that:

> (a) * * *
> Temporary promotions are appropriate only for temporary or emergency situations. A temporary promotion may not be used, for example, as a trial period before permanent promotion, as a means of deciding among candidates for permanent promotion, or as a means of training employees in higher grade duties.
>
> * * * * *
>
> (d) * * * A temporary promotion may not be made permanent without applying the competitive promotion procedures unless the agency made it plain to all interested parties that it might lead to permanent promotion.

As articulated by this court in *Bielec* v. *United States*, 197 Ct. Cl. 550, 560, 456 F. 2d 690, 696 (1972), which rejected plaintiffs' claims to non-competitive promotions to positions upgraded incident to an agency reorganization,

> It is well-settled that service by a government employee in an acting capacity does not entitle him to permanently occupy that position nor to receive the salary incident thereto, as his rights and salary are based solely on the position to which he has been officially appointed. *See Ganse* v. *United States*, 180 Ct. Cl. 183, 186, 376 F. 2d 900 (1967); *Price* v. *United States*, 112 Ct. Cl. 198, 200, 80 F. Supp 542, 543 (1948); *Coleman* v. *United States*, 100 Ct. Cl. 41 (1943); *Dvorkin* v. *United States*, 101 Ct. Cl. 296 (1944), *cert. denied*, 323 U.S. 730; *Amundson* v. *United States*, 128 Ct. Cl. 80, 120 F. Supp. 201 (1954); and *United States* v. *McLean*, 95 U.S. 750 (1877).

Nor is there any question of a constitutional, inherent or vested right to the promotions plaintiffs are claiming. *See, e.g., Testan* v. *United States*, 205 Ct. Cl. 330, 335, 499 F. 2d 690, 693 (1974) (Skelton, J., dissenting), *cert. granted*, 420 U.S. 923 (1975); *Ganse* v. *United States*, 180 Ct. Cl. 183, 186, 376 F. 2d 900, 902 (1967); *Donnelly* v. *United States*, 133 Ct.

Cl. 120, 122, 134 F. Supp. 635, 636 (1955); *Jenson* v. *Olson*, 353 F. 2d 825, 828 (8th Cir. 1965); *Bailey* v. *Richardson*, 182 F. 2d 46, 57 (D.C. Cir. 1950), *aff'd*, 341 U.S. 918 (1951).

Finally, there is perhaps no principle more settled in this area of the law than that promotion and non-promotion of employees within a department or agency of Government is a matter of supervisory discretion not ordinarily subject to judicial review. *See, e.g., Testan* v. *United States*, *supra; Desmond* v. *United States*, 201 Ct. Cl. 507, 526 (1973); *Tierney* v. *United States*, 168 Ct. Cl. 77, 80 (1964); *Pulley* v. *TVA*, *supra; Gnotta* v. *United States*, 415 F. 2d 1271, 1276 (8th Cir. 1969), *cert. denied*, 397 U.S. 934 (1970). This principle was well expressed by Judge Laramore in *Umbeck* v. *United States*, 149 Ct. Cl. 418, 429 (1960), as follows:

> [I]t is the function of the agency rather than the court to make promotions, and to allow plaintiff to recover on this theory would be in effect granting a promotion to plaintiff. It is well settled that this court's jurisdiction extends only to the granting of a monetary judgment. [citations omitted].

See also Bortin v. *United States*, 133 Ct. Cl. 856, 860, 138 F. Supp. 251, 253 (1956).

In short, plaintiffs, by their allegations regarding non-promotion, would have the court remove discretion from the Navy Department and substitute the court's judgment as to who should receive permanent promotions. This would constitute an unwarranted judicial interference with discretionary executive action. Moreover, plaintiffs have not produced the near "irrefragable proof" necessary to overcome the general presumption that the Government has discharged its duties in good faith and in a legal and proper manner. *See Grover* v. *United States*, 200 Ct. Cl. 337, 344 (1973); *Kozak* v. *United States*, 198 Ct. Cl. 31, 35, 458 F. 2d 39, 40 (1972). Accordingly, we find no merit in this first aspect of plaintiffs' case.

III

The Retention Preference Question

Plaintiffs next contend that defendant acted in contravention of the Veterans' Preference Act and applicable reg-

ulations by demoting plaintiffs who were veterans' preference eligibles with the highest retention standings, while retaining at the foreman level competing non-veteran employees possessed of the lowest retention standings. In addition, according to plaintiffs, defendant failed to prepare (and produce) retention registers to support its demotion actions, as purportedly required by 5 C.F.R. §§ 351.404 and 351.501. We do not agree with either of these contentions.

The greater portion of plaintiffs' briefs and arguments in support of the above contentions rely on 5 U.S.C. §§ 3501 *et seq.* and the reduction-in-force regulations promulgated thereunder by the CSC, 5 C.F.R. §§ 351.201 *et seq.* Although plaintiffs have cited various decisions construing the statute and regulations, plaintiffs have not shown how any of these decisions is applicable to the facts of the instant case.

Hilton v. *Sullivan*, 334 U.S. 323 (1948), for example, did not involve a temporary promotion. In that case, the Supreme Court rejected the challenge made to Section 12 of the Veterans' Preference Act by a non-veteran permanent employee of the Charleston Navy Shipyard who had been demoted pursuant to a reduction in force while a veteran permanent employee with less seniority had been retained. A similar, albeit constitutional, challenge to Section 12 was rejected in *White* v. *Gates*, 253 F. 2d 868 (D.C. Cir.), *cert. denied*, 356 U.S. 973 (1958), which was also exclusively concerned with permanent employees affected by a reduction in force. *Reynolds* v. *Lovett*, 201 F. 2d 181 (D.C. Cir. 1952), *cert. denied*, 345 U.S. 926 (1953), to like effect, reversed a Section 12 reduction of veteran permanent personnel at the Mare Island Naval Shipyard, notwithstanding the Navy's assessment of individual qualifications, where non-veteran permanent personnel were retained in their same positions and grades.

Plaintiffs also direct attention to *Adler* v. *United States*, 129 Ct. Cl. 150 (1954); *Parks* v. *United States*, 137 Ct. Cl. 297, 147 F. Supp. 261 (1957); and *Schweizer* v. *United States*, 128 Ct. Cl. 456, 121 F. Supp. 928 (1954). Reliance upon these cases, however, is similarly misplaced. In *Adler*, as in *Reynolds* v. *Lovett*, *supra*, plaintiffs, veteran permanent employees at the New York Naval Shipyard, were demoted pursuant to a reduction in force, while non-veteran permanent employ-

ees were retained. In awarding plaintiffs back pay, this court held that the failure to retain plaintiffs at the higher level positions in preference to non-veteran employees violated their rights under Section 12 of the Veterans' Preference Act. Similarly, in *Parks*, this court held Section 12 violated by the reduction in grade of a veteran permanent employee pursuant to a reorganization of the IRS, where other non-veteran employees, who should have been "bumped" or replaced by plaintiff in accordance with plaintiff's veterans' preference retention status, were retained in their positions. Finally, in *Schweizer*, this court held Section 12 a bar to demotion of a non-wartime veteran, employed at the Philadelphia Navy Yard at the time the 1944 Act was passed, where non-veteran employees were simultaneously retained in their positions.

None of the foregoing cases deals with the termination of temporary promotions. As defendant correctly asserts, such personnel actions are not within the contemplation of the reduction-in-force statute and regulations. Section 12 of the Veterans' Preference Act, as codified in 5 U.S.C. § 3502(a), prescribes the manner in which employees are to be separated or reduced in position or grade incident to a reduction in force, as follows:

> The Civil Service Commission shall prescribe regulations for the release of competing employees in a reduction in force which give due effect to—
> (1) tenure of employment;
> (2) military preference, subject to section 3501(a)(3) of this title [i.e. concerning retired military members];
> (3) length of service; and
> (4) efficiency or performance ratings.

The CSC regulations promulgated under the above statute, 5 C.F.R. § 351 *et seq.*, as amplified and explained in the FPM, Ch. 351, provide specific procedures for effecting reductions in force.

Apparently, plaintiffs contend that, since in their permanent positions they were classified as I–A veterans' preference eligibles, and since under 5 C.F.R. § 335.101 a position change authorized by § 335.102 does not change the competitive status and tenure of an employee, they were entitled to the same retention preference rights in the positions to which they were temporarily promoted as they enjoyed in their

former permanent positions. There are two fallacies in this position.

First, and most obviously, plaintiffs' retention preference standing becomes material only in the event that their release or demotion is occasioned by a reduction in force. In the instant case, only two of the plaintiffs, Mr. Crowley and Mr. Storjohann, were directly affected by such a reduction. As to the remaining three plaintiffs, their basis for appeal must be derived from the statutory and regulatory provisions governing adverse actions in effect at the time plaintiffs initially received their temporary promotions.[8]

Second, as to plaintiffs Crowley and Storjohann, the regulations and the applicable decisions indicate beyond doubt that the holders of temporary promotions are not to be accorded the retention preference otherwise available to them in their permanent positions in a reduction-in-force situation. Except for position changes specifically provided for in 5 C.F.R. § 335.101, a position change does not alter the competitive status and tenure of an employee. A temporary promotion is not one of the position changes authorized by that section.[9] Accordingly, the regulation does not support the

[8] *See* Part IV of this opinion. After the change in the regulations, effective Sept. 4, 1968, the termination of a temporary promotion is no longer considered an "adverse action." *See* 5 C.F.R. § 752.103(b)(5). The CSC's BAR, in interpreting the adverse action regulations in these and similar cases, has consistently avoided retroactive application of the amendments thereto, but has held controlling those regulations existing at the time respective employees initially received their temporary promotions. *See In re William Crowley*, BAR Decision, Aug. 21, 1970, at 4. We see no reason for departing from this policy here.

[9] As amended, subsection (f)(1) of Section 335.102, effective Sept. 4, 1968, eliminates any uncertainty regarding the status of temporary promotions, as follows:

"[A]n agency may:

* * * * *

"(f)(1) Except as otherwise specifically authorized by the Commission, temporarily promote an employee to meet a temporary need for a definite period of 1 year or less and extend such a promotion for a definite period not to exceed 1 additional year. At the end of the period for which the agency temporarily promoted the employee, or when the agency determines that it no longer needs the employee in the position, the agency shall return the employee to the position from which it temporarily promoted him, except when it reassigns or demotes him, without time limitation and with his consent, to a different position. *The return of an employee to the position from which the agency temporarily promoted him under this subparagraph* or his reassignment or demotion to a different position that is not at a lower grade or level than the position from which he was temporarily promoted *is not subject to Parts 351 [reduction in force], 752 [adverse action]*, 771 or 772 of this chapter." (emphasis added).

argument that retention preference standing attaches to the employee, regardless of the nature of his position (i.e., temporary or permanent), rather than to the job he permanently holds. Were plaintiffs demoted from their *permanent* positions as Pipefitter and Machinist, respectively, pursuant to a Shipyard reduction in force in which non-veterans were retained, there could be no question that such action would violate their entitlement to absolute preference over non-veterans in those same positions. Where their demotions, as here, are from temporary promotions back to their former permanent positions, however, the statute and regulations afford them no such entitlement. Section 351.601 of the regulations provides that:

> An agency may not release a competing employee from a competitive level while retaining in that level an employee with a specifically limited temporary appointment * * *.[10]

The CSC has consistently interpreted this section to mean that temporary promotees, such as the plaintiffs, must be returned to their former permanent positions before a reduction in force at the higher competitive level can be commenced.[11] It follows that, in so demoting plaintiffs, defendant was merely complying with the applicable regulations.

This interpretation of the regulations, moreover, is consistent with the Veterans' Preference Act. Such, indeed, was

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[10] As amended, effective Sept. 4, 1968, Section 351.601 provides:

"An agency may not release a competing employee from a competitive level while retaining in that level an employee with * * * a specifically limited temporary *promotion.*" (emphasis added.)

Subsection (e) of Section 351.201, as amended, effective Sept. 4, 1968, makes even clearer the exclusion of temporary promotees from the retention preference accorded veterans in reductions in force:

"(e) this part [i.e., reduction in force] does not apply to the termination of a temporary promotion or to the return of an employee to the position from which he was temporarily promoted * * *."

To similar effect are the amendments to Section 351.404(c), effective Sept. 4, 1968, which now directs the agency involved to "enter on a list *apart from the retention register* the name and expiration date of the appointment or *promotion* of each employee serving in a position in the competitive level under specifically limited temporary appointment or *temporary promotion* * * *."

[11] *See In re Kenneth E. Thompson*, BAR Decision, Feb. 2, 1970, at 5–6 (quoting letter from L. A. Moyer, Executive Director and Chief Examiner, CSC, to Rear Adm. P. B. Nibecker, Chief, Office of Industrial Relations, Navy Department, Feb. 15, 1949), appended to *Defendant's Cross-Motion*, at 103–104.

the holding of *Elder* v. *Brannan*, 341 U.S. 277, 283 (1951), which sustained the retention of non-veteran permanent employees over veteran temporary employees in a reduction-in-force situation, on the ground that the regulations group employees *by tenure* and limit the reach of veterans' preference to competing employees of the same group. *See O'Hare* v. *United States*, 153 Ct. Cl. 55, 59–60, 288 F. 2d 705, 707 (1961); *Cohen* v. *McNamara*, 282 F. Supp. 308, 312 (E.D. Pa. 1968). The obvious rationale underlying this initial grouping by tenure instead of by veterans' status was to avoid the result of permitting veteran temporary promotees, during every reduction in force, to automatically displace non-veterans with greater seniority holding the same positions on a permanent basis. Were management required in every instance, as plaintiffs contend, to use reduction-in-force procedures to return temporary promotees to their permanent grades, the result would be to obviate the utility of the temporary promotion as a device for meeting short-term needs. We do not believe this was the intent of the drafters of the Veterans' Preference Act. Nor have plaintiffs produced any evidence of such intent. Accordingly, we can find no merit in this second aspect of plaintiffs' case.

IV

The Adverse Action Question

Plaintiffs' final argument is that defendant's terminations of their temporary promotions, treated as adverse actions within the meaning of Section 14 of the Veterans' Preference Act, 5 U.S.C. § 7512, were not effected in accordance with the substantive standard [12] set forth in 5 C.F.R. Pt. 752.

Although the applicable regulations have since been amended,[13] there is no question that under the law in effect

[12] There is no dispute regarding defendant's compliance with the procedural requirements of 5 C.F.R. Pt. 752.

[13] As amended, subsection (5) of 5 C.F.R. § 752.103(b), effective Sept. 4, 1968, provides that:

"(b) * * * In no case, however, does any of this part apply to:

* * * * *

"(5) An action terminating a temporary promotion within a maximum period of two years and returning the employee to the position from which he was temporarily promoted or reassigning or demoting him to a different position that is not at a lower grade or level than the position from which he was temporarily promoted."

See also FPM, Ch. 335, Subch. 1—8(e)(1).

prior to September 1968 and, hence, controlling in this case,[14] the termination of temporary promotions and the return of plaintiffs to their former permanent positions is an adverse action [15] and, hence, must be "for such cause as will promote the efficiency of the service."

What constitutes such "cause" as to justify the return of veteran temporary promotees to their former permanent positions is not altogether clear from the regulations and pertinent decisions. Section 752.104(a) of 5 C.F.R. states only that "[a]mong the reasons that constitute 'such cause as will promote the efficiency of the service' for this purpose are the reasons for disqualification of an applicant listed in § 731.201(b)–(g) of this title." Section 731.201 enumerates various types of disqualifying conduct, concluding with the general ground of "any * * * other disqualification which makes an individual unfit for the service." Virtually all of the reported cases in this area similarly concern questions of whether specific kinds of conduct justify discharge or demotion on grounds of unsuitability or unfitness. *See, e.g.*, *Norton* v. *Macy*, 417 F. 2d 1161 (D.C. Cir. 1969) (homosexual conduct); *Studemeyer* v. *Macy*, 321 F. 2d 386 (D.C. Cir. 1963), *cert denied*, 375 U.S. 934 (1963) (insubordination); *Taylor* v. *Macy*, 252 F. Supp. 1021 (S.D. Cal. 1966) (criminal convictions that had been expunged). Clearly, the suitability or fitness of the plaintiffs in this case for the higher level positions is not questioned. Accompanying each of the termination notices issued to the plaintiffs was the statement that "[a]lthough this termination is technically classified as an 'adverse action,' it is not in any way a reflection on your performance." *Defendant's Cross-Motion*, at 7.

Indeed, distinguishing this case from prior adverse action cases is the temporary and, hence, conditional nature of the positions which plaintiffs received and from which they were subsequently demoted. *See Powers* v. *Gold*, 124 F. Supp. 93,

[14] *See* note 8 *supra*.

[15] *See* FPM, Ch. 335, Subch. 1–8(d): "A change to lower grade after a temporary or limited promotion is subject to the adverse-action procedures of Chapter 752 under any of the following circumstances:—If the period of promotion exceeds 90 days."

95-96 (D. Mass. 1953). Prior to each such temporary promotion, pursuant to FPM, Ch. 335, Subch. 1-8, each of the plaintiffs was issued a standard form memorandum agreement expressly indicating that the promotion being offered was temporary in nature, for a specifically limited duration and for accomplishment of a designated purpose. Among the representations and conditions stated in the agreement were the following:

> b. * * * this temporary promotion is expected to continue for the period shown above. *It may, however, be terminated earlier whenever the temporary condition for which it was made no longer exists, or whenever, for other reasons, it is determined to be in the best interest of the Shipyard to do so.* (emphasis added.)
>
> * * * * *
>
> d. * * * You will return to your present position and pay step whenever the basis for your temporary promotion no longer exists, or whenever other reasons occur which warrant terminating your temporary promotion.

Each of the plaintiffs signed this agreement, in advance of his temporary promotion, with the statement that "I understand and agree to the conditions of my proposed temporary promotion as explained above." Each of the plaintiffs, in addition, was issued a 30-day advance notice of proposed termination, setting forth the specific reasons therefor (e.g., decrease in workload). Where plaintiffs were thus appropriately advised of the particular need occasioning their temporary promotions, and that they would be returned to their former positions upon expiration of that need, it would appear to follow that their subsequent reduction *in accordance therewith* would be "for such cause as will promote the efficiency of the service." This, in effect, was the Commission's finding in each of the cases now before us.

Plaintiffs contend, however, that their temporary promotions were terminated not in accordance with the terms of their respective agreements, but because the Navy had elected to replace them by retaining in and/or permanently promoting to the higher level positions certain non-veteran employees who had received their temporary promotions subsequent to plaintiffs. In sole support of this purported "rule" that

an agency, in a non-reduction-in-force decrease, must first demote those employees most recently temporarily promoted, plaintiffs cite *In re Kenneth E. Thompson*, BAR Decisions, March 18, 1969 and February 2, 1970; *In re James L. Bragdon*, BAR Decision, March 26, 1970; and *In re Chester A. Odiorne*, Appeals Examining Office (AEO), CSC, Decision, August 7, 1969. These decisions, however, are either clearly distinguishable from the instant case, or are otherwise, in our judgment, unpersuasive on the legal questions here involved.

In *Odiorne*, for example, the AEO reversed the Navy Department's termination of plaintiff's temporary promotion on the ground that the Navy had retroactively applied a new regulation establishing a two-year maximum duration for temporary promotions made on or after September 1, 1968. Since plaintiff had been temporarily promoted prior to that date, the regulation was inapplicable and, hence, plaintiff's return to his former position was determined to be not for such cause as would promote the efficiency of the service.

More closely apposite are the BAR decisions in *Thompson*. Like plaintiffs, Mr. Thompson had been temporarily promoted to the position of Foreman (Leadingman) Pipefitter (in February 1967). The Shipyard's subsequent termination of this promotion (on July 14, 1968) was sustained by the CSC Regional Office, but reversed by the BAR (on March 18, 1969), on the ground that the reason for the termination was to replace plaintiff with other subsequently qualified employees who had received temporary and/or permanent promotions. Thereafter, Mr. Thompson received a second termination notice (May 23, 1969), pursuant to a reduction in force at the Shipyard's Foreman Pipefitter level. On appeal, the Regional Office again sustained the Shipyard's action, but the BAR, on February 2, 1970, again reversed, on the ground that affirmance of the second termination would permit the Navy, in effect, "to accomplish through reduction-in-force application what previously it could not accomplish" in the non-reduction-in-force situation which had occasioned plaintiff's first termination and successful appeal.

Plaintiffs argue that the *Thompson* "rule," i.e., that employees last temporarily promoted must be first demoted when the temporary workload decreases, is controlling in the instant case. Defendant counters that *Thompson* is factually distinguishable or, in the alternative, that it was wrongly decided. Insofar as *Thompson* purports to carve an exception to 5 C.F.R. § 351.601, which, as earlier discussed, effectively requires the return of all temporary promotees to their lower permanent positions preliminary to any reduction in force at the higher competitive level, we find it unpersuasive. The original purpose in applying Section 14 (adverse action), rather than Section 12 (reduction in force), of the Veterans' Preference Act to the termination of temporary promotions was two-fold: (1) to afford veteran temporary promotees certain procedural safeguards against purely arbitrary agency action, and (2) at the same time, to avoid the result of permitting such veterans (whose status and tenure are not changed after promotion), upon a decrease in workload, to automatically displace all non-veterans who had been occupying the higher grade positions on a permanent basis. In arguing, purportedly on the strength of *Thompson*, that veteran temporary promotees must in every decreased workload situation be retained and/or permanently promoted over non-veterans who received their temporary or permanent promotions subsequent to the veterans, plaintiffs, in effect, urge us to apply the reduction-in-force regulations to non-reduction-in-force situations, thereby ignoring both the governing regulations and the long-established policy of the CSC in the temporary promotion area. We decline to do so.

Nor, in our opinion, does *Thompson* necessarily prescribe so drastic a change in previous law and policy. Limited to its precise facts, the decision deals less with the relative timing of temporary promotions *per se*, than with the particular promotion register from which competing temporary promotees were selected. Thus, as indicated by the BAR, in its decision in the *Crowley* appeal of August 21, 1970, *Defendant's Cross Motion*, at 48–49, the competing employees in *Thompson* had been temporarily promoted from a competitive promotion register established after the one on

which Mr. Thompson had qualified. In contrast, according to defendant's submissions, *no* competing employees retained or permanently promoted over plaintiffs in the instant case had been selected from a register established after the one on which plaintiffs themselves, if at all, had qualified. Plaintiffs, for their part, present little or no evidence to refute this assertion. The "rule", if any, enunciated by the BAR in *Thompson*, therefore, is that employees last *qualified* (by inclusion on a competitive promotion register, i.e., not those employees last *temporarily promoted*) must be first demoted when the temporary workload decreases. Thus narrowly viewed, the "rule" comports with the policy and preferences underlying the Federal Merit Promotion program, while preserving that measure of discretion (e.g., as between competing temporary promotees selected from the *same* register) essential to the utility of the temporary promotion device.[16]

Finally, it is by now a commonplace principle that where an agency, as here, has complied with the prescribed procedural requirements, this court's review must necessarily be limited to determination of whether that agency's action was arbitrary or capricious, so grossly erroneous as to be in bad faith, unsupported by substantial evidence or in excess of its properly delegated authority. *Morelli* v. *United States*, 177 Ct. Cl. 845, 858 (1966); *see Boyle* v. *United States*, 207 Ct. Cl. 27, 34, 515 F. 2d 1397, 1401 (1975); *Poschl* v. *United States*, 206 Ct. Cl. 672, 682 (1975); *Ricci* v. *United States*, 205 Ct. Cl. 687, 693, 507 F. 2d 1390, 1393 (1974); *Grover* v. *United States*, 200 Ct. Cl. 337, 343 (1973). As stated in *Boyle*, *supra*, "[i]t is not our function to substitute our judgment for that of the employing agency or the Civil Service Commission; rather we review the case to determine whether their action was reasonable in light of all the evidence." *See Schlegel* v. *United States*, 189 Ct.

[16] *See* Pt. II of this opinion, *supra*. The BAR's decision in *Bragdon*, also cited by plaintiffs, would appear in full accord with our interpretation of *Thompson* here. In *Bragdon*, the Bar reversed the Navy's termination of plaintiff's temporary promotion on the ground that the actual reason for the Navy's action was its selection of another employee for promotion to an additional permanent foreman's billet from a *new* register of qualified eligibles. Since plaintiff had qualified for promotion from a previous register, plaintiff's demotion was determined to be not for such cause as would promote the efficiency of the service.

Cl. 30, 36, 416 F. 2d 1372, 1375 (1969), *cert. denied*, 397 U.S. 1039 (1970); *Harrington* v. *United States*, 174 Ct. Cl. 1110, 1117 (1966); *Guiness* v. *United States*, 149 Ct. Cl. 1, 6, *cert. denied*, 363 U.S. 819 (1960). In applying this standard, moreover, the presumption is that the Government officials have acted in good faith in making their decision. *Grover* v. *United States*, *supra; Travis* v. *United States*, 199 Ct. Cl. 67, 70 (1972); *Horne* v. *United States*, 190 Ct. Cl. 145, 150, 419 F. 2d 416, 419 (1969); *Morelli* v. *United States*, *supra; Greenway* v. *United States*, 175 Ct. Cl. 350, 362, *cert. denied*, 385 U.S. 881 (1966).

In the instant case, each of the plaintiffs was, as previously stated, informed in advance that his promotion was to be temporary in nature, that it was intended solely to meet a special and temporary need, and that it would be terminated and the plaintiff returned to his former permanent position upon expiration of that need, or whenever such termination was otherwise considered to be in the best interest of the Service. During the time plaintiffs served at the higher grade positions, they were compensated at the higher rate commensurate with those positions. When these promotions were subsequently terminated, it was clearly indicated that such termination was not intended as a reflection on plaintiffs' respective capabilities or performance. No taint or stigma resulted. Plaintiffs were not thereafter permanently precluded from actively competing for subsequent permanent promotions. Plaintiffs have failed to discharge their burden of showing that defendant's actions were arbitrary, capricious or contrary to the applicable statutes and regulations. That other competing employees, who had received temporary or permanent promotions subsequent to plaintiffs, were retained at the higher level positions when plaintiffs' temporary promotions were terminated, may well have led plaintiffs to believe they were treated unfairly. However, such a showing, standing alone, does not for the reasons stated above, entitle plaintiffs to recover.

Accordingly, we deny plaintiffs' motion for summary judgment, grant defendant's cross-motion for summary judgment, and dismiss plaintiffs' petition.

Syllabus

527 F. 2d 621

W & W FERTILIZER CORPORATION v. THE UNITED STATES

[No. 17–74. Decided December 17, 1975]*

ON DEFENDANT'S AND PLAINTIFF'S MOTIONS FOR SUMMARY JUDGMENT

Taxes; income tax; small business corporation; termination of election; *inter vivos* trust as shareholder in corporation.—In 1965 plaintiff elected to be treated as a Subchapter S small business corporation effective for its taxable year ended March 31, 1966 and subsequent years unless terminated. Prior to February 25, 1970 plaintiff had only two shareholders, Lemuel and Fred Woods (owning 47% and 53% of the stock, respectively); on that date Lemuel established a revocable *inter vivos* trust transferring all his shares in the corporation to the trust as part of its assets. All of the income of the trust was taxable to and reported for Federal income tax purposes by Lemuel, and Lemuel was the sole income beneficiary for life, the remainder upon his death being divided among his wife and family. The trust agreement provided that Lemuel could alter, amend, modify, revoke or withdraw assets from the trust upon 90 days' written notice to the trustee of the proposed exercise of such right. Plaintiff seeks to recover Federal corporate income taxes which it paid, under protest, for its taxable year ended March 31, 1970, contending that its small business corporation status continued after Lemuel transferred his shares to the trust because the trust should be disregarded and Lemuel accorded status as the owner. It is *held* (1) that whatever the reasons for creating the trust, having chosen to so plan his estate and having enjoyed the advantages of this arrangement, neither Lemuel nor plaintiff can now avoid the tax consequences of Lemuel's choice and the separate identity of the trust; (2) that the trust is a taxable entity of the kind addressed in Sec. 1371(a) and cannot be ignored for qualification purposes by looking through it to the beneficiary; (3) that the "grantor trust rules" of Sec. 671, et seq. of the Code are not analogous to the qualification requirements of Sec. 1371(a); (4) that Treas. Regs. §§ 1.1371–1 and 1.1372–4 correctly interpret Code Sec. 1371(a)(2) to the extent that it prohibits the subject revocable *inter vivos* trust from becoming a shareholder in a Subchapter S small business corporation; and (5) that accordingly plaintiff's Subchapter S election terminated upon transfer of Lemuel's shares into the hands and ownership of the trust. Plaintiff is not entitled to recover, defendant's motion for summary judgment is granted, plaintiff's cross-motion is denied, and the petition is dismissed.

*On March 16, 1976 plaintiff filed a petition for a writ of certiorari.

Syllabus

Taxes; income tax; small business corporation, election of as to taxable status.

[1] Under Sec. 1372(e)(3) of the Internal Revenue Code of 1954, a Subchapter S election by a small business corporation is terminated when the organization ceases to qualify as a small business corporation as defined in Sec. 1371(a), as when it does not have as a shareholder a person (other than an estate) who is not an individual.

Internal Revenue ⇐ 1355

Taxes; income tax; small business corporation, election of as to taxable status; congressional intent; form v. substance.

[2] Subchapter S of the 1954 Code was enacted to afford a qualified "small business corporation" the option of eliminating Federal income tax at the corporate level, thereby avoiding double taxation in that it pays no tax and its income is passed through to its shareholders. Congress' motive for including qualification requirements was to insure (1) the efficacy of the law's remedial purpose to make the same tax treatment previously available only to proprietorships and partnerships available to those economically similar small corporate business structures, and (2) avoidance of an administrative burden otherwise falling on the Government in applying the law. Thus, the organizational form of the shareholder constitutes the substance which governs in testing eligibility of a corporation for small business corporation status for Federal tax purposes.

Internal Revenue ⇐ 1355

Taxes; income tax; small business corporation, election of as to taxable status; revocable *inter vivos* trust as shareholder, tax consequences.

[3] Where "L" a Subchapter S small business corporation shareholder, chose to employ a revocable *inter vivos* trust, whose assets included his corporate shares, in connection with his estate plan, and found that the trust, as a shareholder in his small business corporation, adversely affected the corporation's tax status, "L" must accept the tax consequences of his choice, whether contemplated or not. The tax law does not permit a taxpayer to embrace a device for one purpose and ignore it for tax purposes.

Internal Revenue ⇐ 1355

Taxes; income tax; small business corporation, election of as to taxable status; qualifying shareholders.

[4] While Treas. Reg. § 1.1371–1(d)(1) recognizes that persons for whom stock in a Subchapter S corporation is held by a nominee, agent, guardian or custodian will generally be considered shareholders of the corporation, it cannot be deduced from this that a trust can either qualify as a shareholder under Sec. 1371(a) of the Code or be disregarded as a shareholder, because trusts, unlike nominees, guardians, agents and custodians, are recognized for tax reporting

Syllabus

purposes. Thus, where a Subchapter S small business corporation shareholder transferred his shares of stock to a revocable *inter vivos* trust in connection with his estate plan, the trust is a taxable entity of the kind addressed in Sec. 1371(a), and cannot be ignored for purposes of qualification for small business tax treatment by looking through it to the beneficial owner.

Internal Revenue ⇐ 1355

Taxes; income tax; estates, trusts and beneficiaries; grantor trust rules; trust as small business shareholder.

[5] The "grantor trust rules" of Sec. 671, et seq. arose under the Code because it was recognized by Congress that taxation of income is not concerned so much with refinements of title as it is with actual command over the property taxed, and these rules treat the grantor as if he were the owner in cases where he has reserved to himself some of the powers normally attendant upon outright ownership. Since the purpose of the grantor trust rules is expansion, and since Sec. 1371(a) qualification requirements for Subchapter S tax status are restrictive, the two Code provisions are not analogous, and their comparison is not supportive of taxpayer's contention that because the grantor of the subject trust is taxed on the trust income the trust should be ignored for Sec. 1371(a) qualification requirements.

Internal Revenue ⇐ 1355

Treasury regulations; construction and operation; small business corporation, election of as to taxable status.

[6] Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes; they constitute contemporaneous constructions by those charged with administration of the statutes and should not be overruled except for weighty reasons. Treas. Reg. §§ 1.1371–1 and 1.1372–4 correctly interpret § 1371(a)(2) of the Code to the extent that the latter prohibits an *inter vivos* revocable trust, such as the subject trust, from becoming a shareholder in a Subchapter S "small business corporation."

Internal Revenue ⇐ 1355

Taxes; income tax; small business corporation, election of as to taxable status; termination of election; *inter vivos* trust as shareholder.

[7] When "L", one of two shareholders in a Subchapter S "small business corporation," transferred all of his corporate shares to an *inter vivos* trust, reserving to himself the right to revoke the trust at any time and to revest title to the trust's assets in himself providing that such right be exercised only in writing and after 90 days' notice to the trustee, such a trust is not an individual within the intendment of Sec. 1371(a)(2) of the Code, and is therefore prohibited from becoming a Subchapter S shareholder. Under such circumstances, the corporation's prior election to become a Sub-

chapter S "small business corporation" terminated when "L" transferred his shares to the trust.

Internal Revenue ⇐ 1355

Sherwin P. Simmons, attorney of record, for plaintiff. *Harold W. Mullis, Jr.*, *Ronald S. Nauveen* and *Trenam, Simmons, Kemker, Scharf & Barkin*, of counsel.

Charles E. Auslander, Jr., with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Theodore D. Peyser* and *Donald H. Olson*, of counsel.

Before COWEN, *Chief Judge*, LARAMORE, *Senior Judge*, and BENNETT, *Judge*.

LARAMORE, *Senior Judge*, delivered the opinion of the court:

This is an action to recover Federal corporate income taxes paid by plaintiff, under protest, for the taxable year ended March 31, 1970. The sole question presented is whether the taxpayer's prior election to be treated as a "small business corporation" under Subchapter S of the Internal Revenue Code of 1954 [1] terminated when one of its shareholders transferred his stock to a revocable *inter vivos* trust.[2]

The relevant facts are as follows: Plaintiff, W&W Fertilizer Corporation (hereinafter referred to as "W&W" or as "taxpayer"), was incorporated under the laws of the State of Florida in 1907. In 1965 the company elected to be treated as a Subchapter S corporation, effective for its taxable year ended March 31, 1966, and subsequent years unless terminated. Immediately prior to February 25, 1970 (the date of the transfer to the trust), W&W had only two shareholders: Lemuel P. Woods, owning 47 percent of the company's stock, and Fred J. Woods, his brother, owning 53 percent. On the above date, Lemuel established the Lemuel P. Woods Revocable Trust (hereinafter referred to as the "Woods Trust") pursuant to a revocable trust agreement.

[1] All citations to sections hereinafter are, unless otherwise indicated, in reference to the Internal Revenue Code of 1954.

[2] Subchapter S (26 U.S.C. §§ 1371–1379), relieves an electing "small business corporation" of Federal corporate income tax liability (other than the tax imposed on certain capital gains by section 1378) for the period during which such election remains effective.

Among the assets transferred to the trust on that date were all of the shares of W&W stock owned by Lemuel.

The Woods Trust was a revocable *inter vivos* or living trust, all of the income of which was taxable to and reported for Federal income tax purposes by Lemuel. As the grantor, Lemuel had reserved in himself the right to revoke at any time and to revest title to the trust's assets in himself, with the provision, however, that such right be exercised only in writing and after 90 days' notice to the trustee.[3] A bank was designated as co-trustee, along with Julia Woods, Lemuel's wife. Lemuel was sole income beneficiary for life, and at the time of the trust's inception, the remainder was variously divided among his wife and family.

Section 1372(e)(3)[4] of the Code provides that a Subchapter S election is terminated at such time as a corporation ceases to be a "small business corporation" as defined in section 1371(a).[5] Subsection 2 of section 1371(a) specifies that a small business corporation may not "have as a shareholder a person (other than an estate) who is not an individual."

In light of sections 1371(a)(2) and 1372(e)(3), it is understandably not disputed that if during the taxable year ended

[3] Article eleven of the revocable trust agreement provided as follows: "Trustor reserves the right during his lifetime to alter, amend, modify or revoke this trust, or to withdraw assets from the trust estate or to require changes in the investments of the trust estate, and this right may be exercised at any time and from time to time by any instrument in writing signed by Trustor; provided, however, that Trustee may, at its option, require that it be given written notice at least ninety days prior to the effective date of any proposed alteration, amendment, modification or revocation of this trust or withdrawal of assets from the trust estate."

[4] "SEC. 1372. ELECTION BY SMALL BUSINESS CORPORATION. * * * (e) *Termination* * * *. (3) *Ceases to be small business corporation.* An election under subsection (a) made by a small business corporation shall terminate if at any time—(A) after the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or (B) after the day on which the election is made, if such election is made after such first day, the corporation ceases to be a small business corporation (as defined in section 1371(a)). Such termination shall be effective for the taxable year of the corporation in which the corporation ceases to be a small business corporation and for all succeeding taxable years of the corporation."

[5] "SEC. 1371. DEFINITIONS. (a) *Small Business Corporation.* For purposes of this subchapter, the term 'small business corporation' means a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not—(1) have more than 10 shareholders; (2) have as a shareholder a person (other than an estate) who is not an individual; (3) have a nonresident alien as a shareholder; and (4) have more than one class of stock."

March 31, 1970 taxpayer had as a shareholder a person who was not an individual, its Subchapter S election terminated. Both parties agree that a trust is not an individual within the meaning of section 1371(a)(2), and is, therefore, prohibited from becoming a Subchapter S shareholder. Hence, the resolution of this case turns on whether the revocable *inter vivos* trust described herein is to be accorded recognition for Federal tax purposes as a shareholder in taxpayer or, instead, whether the grantor-beneficiary is to be so recognized and the trust disregarded.

The government contends that when Lemuel transferred his shares to the Woods Trust, taxpayer's Subchapter S election terminated because, having a trust as a shareholder, it ceased to be a qualified "small business corporation" within the meaning of section 1371(a). Taxpayer, however, urges that "small business corporation" status continued even after the transfer because the Woods Trust should be disregarded, and Lemuel, the grantor, still accorded status as the owner.

In support of this, taxpayer makes three basic contentions. The first is that it is appropriate in this case to apply the well-settled rule that substance must govern over form. It is urged that because Lemuel retained *de facto* and *de jure* control over the trust *res*, in substance he, not the trust, must be regarded as the owner of the trust property. The second argument is that Lemuel never surrendered the beneficial interest in his W&W shares, and it is this interest that should control for purposes of deciding whether he remained the shareholder within the contemplation of section 1371(a)(2). Finally, taxpayer urges that uniform application of certain Federal tax principles compel recognition of the grantor as the "tax" owner of the shares nominally held by the Woods Trust. Paramount among these principles is what is termed the "grantor trust rules," embodied in the Internal Revenue Code, which hold that a grantor of a trust who retains either administrative control, a reversionary interest, power to control beneficial enjoyment, or the power of revocation, will be taxed on the income derived from the assets of the trust. (Section 671, *et seq.*)

For reasons which follow, we reject all three points and hold instead that taxpayer's Subchapter S election termi-

nated upon the transfer of the shares in question into the hands and ownership of the Woods Trust.

I.

In its first contention, taxpayer cautions us against the exaltation of form over substance by reminding of the fact that Lemuel, as grantor of the trust, retained a quantum of economic control over the trust *res* by retaining the power to revoke. This power, along with his ability to influence the trustees' administrative decisions, is said, in economic substance, to make him the owner of the shares of taxpayer held by the Woods Trust.[6]

However, one of the persistent problems of income taxation, as of other branches of the law, is the extent to which legal consequences should turn on the economic substance of a transaction rather than on its form. It is easy to say that substance should control, but in practice form usually has some substantive consequence, so that if two transactions differ in form, they will probably not be identical as to substance. Congressional enactments of tax law often take note of this. To determine where the true substance of a particular enactment lies requires an inquiry into the reason for the passage of the law.

Subchapter S was enacted to efford a qualified "small business corporation" the option of eliminating Federal income tax at the corporate level, thereby avoiding double taxation. S. Rep. No. 1983, 85th Cong., 2d Sess. 87 (1958), (1958–3 Cum. Bull. 922, 1008). If a corporation qualifies, it pays no tax and its income is "passed through" to its shareholders. An examination of the legislative history of the Act reveals that Congress' motive for including qualification requirements was to insure both the efficacy of the law's remedial purpose and the avoidance of an extreme administrative burden otherwise falling on the government in applying the law. Congress, therefore, expressly incorporated a require-

[6] While we reject taxpayer's first contention for other reasons set out below, we do note that Lemuel's economic control over the trust property was not plenary. Under the terms of the trust agreement the trustee could, at its option, require 90 days' written notice prior to the effective date of any proposed exercise of control by the grantor-beneficiary. See n. 3, *supra*.

ment of form into the Act by excepting certain types of business organization from the ambit of the law's effect.

More specifically, section 1371(a)(2) was intended to effectuate two congressional objectives. *Fulk & Needham, Inc.* v. *United States*, 411 F. 2d 1403 (4th Cir. 1969). First, it was designed to make the same tax treatment previously only available to proprietorships and partnerships also available to those small corporate business structures economically similar to proprietorships and partnerships. However, the similarity to partnerships and proprietorships was not complete under the congressional scheme. While partnership earnings may quite properly be passed through any type of business organization entitled by law to participate in a partnership, Congress expressly limited the availability of the special similar tax treatment to certain specified forms of business organization. The existence of a trust as a shareholder in a Subchapter S corporation would complicate the structure by adding another entity through which earnings would of necessity be passed. Congress anticipated this type of circumvention of the Act's objective by specifying qualification requirements of form for Subchapter S corporation shareholders.

The second, and equally compelling, reason for the adoption of the qualification requirement of section 1371(a)(2), was to avoid placing an enormous administrative burden on the government of tracing earnings to, and possibly through, a widely diversified and multitiered group of shareholders. If the Internal Revenue Service were required to verify and monitor the identity of owners of artificial entities, themselves the owners of Subchapter S shares, the task would be monumental.[7] Such a possibility was obviated by specifically prohibiting persons "other than individuals" from owning Subchapter S stock.

[7] For example, in 1970 over 250,000 corporations existed that had elected to be treated as Subchapter S corporations. Statistics of Income, 1970, Corporation Income Tax Returns, Treasury Department Publication 16, p. 1. If the Internal Revenue Service had to verify how many beneficiaries there were who, by disregarding their trust, were to be treated as shareholders, and to identify who the taxpayers actually were, such a procedure would amount to a very great burden. Further, tax planners could structure multitiered setups (for legitimate tax purposes) wherein it might be impossible to trace income and to identify taxpayers.

In light of these two objectives, the impact of the qualification requirements upon the question of form and substance presented in this case was made abundantly clear in the Senate Committee Report, S. Rep. No. 1983, 85th Cong., 2d Sess. 217–218 (1958), (1958–3 Cum. Bull. 922, 1138–1139):

> Under section 1372(e)(3), an election terminates if the corporation ceases to be a small-business corporation. Thus, if an eleventh person or a nonresident alien becomes a shareholder in the corporation, *if a corporation, partnership, or trust becomes a shareholder*, or if another class of stock is issued by the corporation, *the election is terminated.* [Emphasis supplied.]

In our view, the above language spells clearly that the organizational form of the would-be shareholder constitutes the substance which must be examined when applying the qualification requirement contained in section 1371(a)(2).

The United States Court of Appeals, Fourth Circuit, has twice decided this same issue as applied to testamentary trusts. *Fulk & Needham, Inc.* v. *United States*, *supra; Old Virginia Brick Co.* v. *Commissioner*, 367 F. 2d 276 (4th Cir. 1966). In *Fulk*,[8] the taxpayer contended that the trust should be disregarded as lacking economic reality, because even if a trust existed under state law, it was not a trust in substance which should be recognized for purposes of Federal income taxation. It was further argued that since the beneficiary-trustee had been taxed on all income to the trust and treated the assets as her own, she, and not the trust, was the true "owner" of the shares. The court rejected this argument, stating at page 1406:

> The formula employed by Congress in § 1371(a)(2) in defining a small business corporation entitled to the benefits of subchapter S, speaks of a domestic corporation which does not have as a shareholder "a person (other than an estate) who is not an individual." By

[8] A partner in a construction firm died and his share passed to a simple trust which was to pay the income to his wife for life, the trust to cease on her death and the corpus to pass to his daughters. After the testator's death, the partnership was incorporated and a portion of the shares of the new corporation were issued to the "Trustees of The A. P. Fulk Estate." The next year the estate was closed and the widow and daughters took the shares as co-trustees. Subsequently, the corporation filed an election for Subchapter S status which was determined to be invalid by the Internal Revenue Service.

necessary implication a corporation in which a trust is a shareholder does not qualify.

The language of the Fourth Circuit quoted above is equally applicable to and determinative of the issue now before us. Lemuel chose to employ a revocable *inter vivos* trust in connection with his estate plan and the Woods Trust clearly has substance. Tax law simply does not permit a taxpayer to embrace such a device for one purpose and yet ignore it for tax purposes. *Cf. Commissioner* v. *Danielson*, 378 F. 2d 771 (3d Cir. 1967), *cert. denied*, 389 U.S. 858 (1967); *Dietzsch* v. *United States*, 204 Ct. Cl. 535, 498 F. 2d 1344 (1974). Indeed, the discovery by Lemuel that his chosen estate plan had an adverse effect on the tax status of his corporation appears to be precisely what the Supreme Court had in mind when, in *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974), it stated, at page 149:

> * * * while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, * * * [citations omitted] and may not enjoy the benefit of some other route he might have chosen to follow but did not.

Additionally, taxpayer's argument that the trust should be disregarded ignores the apparent principal purpose of its creation.[9] Lemuel had the right to income on taxpayer's stock prior to creating the trust, but the property would have been subject to probate and the possible delays and expenses attendant thereto. By creation of the trust, Lemuel retained the income from the stock (as before), but he created a new estate plan which would have considerable new consequences under Florida law upon his death. As well as asking us to ignore the testamentary consequences which follow from creation of the trust, taxpayer would have us ignore the fact that the trust took title to Lemuel's real property and securities, it paid his taxes, it made investments, it delivered title to securities and real property, and provided financing for at least one of his businesses.

[9] We can only speculate as to the reason for creating the trust. The possibilities include facilitating the transfer of the title to the assets on Lemuel's death, avoiding probate and the expenses attendant thereto, and providing for management if Lemuel became incompetent.

The Supreme Court has rejected the proposition that a form of business organization once selected and employed for non-tax reasons may later be disregarded at tax time. *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422 (1949); *Moline Properties, Inc.* v. *Commissioner*, 319 U.S. 436 (1943). This court has followed the tenor of these decisions. *Harrison Property Management Co., Inc.* v. *United States*, 201 Ct. Cl. 77, 475 F. 2d 623 (1973), *cert. denied*, 414 U.S. 1130 (1974); *Carver* v. *United States*, 188 Ct. Cl. 202, 412 F. 2d 233 (1969). The principles applied in these cases apply here as well. Whatever the reasons for creating the Woods Trust, it is a fact that the Woods Trust conducted business. Thus, having chosen to operate in this fashion, having enjoyed the advantages of this arrangement, neither Lemuel nor taxpayer can now avoid the tax consequences of Lemuel's choice and the separate identity of the Woods Trust. *Cf. Love* v. *United States*, 119 Ct. Cl. 384, 96 F. Supp. 919 (1951).

II.

Taxpayer's second argument in support of its claim is that for purposes of determining who the shareholders are under the provisions of Subchapter S, beneficial ownership rather than legal title controls. Much is made of the cases and Revenue Ruling which look to beneficial ownership of Subchapter S stock in determining which party or parties are required to file the "consent" to election required by section 1372(a).[10] *William B. Wilson*, 34 T.C.M. 463 (1975); *Kean* v. *Commissioner*, 469 F. 2d 1183 (9th Cir. 1972); *Alfred N. Hoffman*, 47 T.C. 218 (1966), *aff'd sub nom. Hoffman* v. *Commissioner*, 391 F. 2d 930 (5th Cir. 1968); Rev. Rul. 70–615, 1970–2 Cum. Bull. 169. However, these authorities deal with stock held by one as a nominee of another, rather than in trust as in the instant case.

The Treasury Regulations under Subchapter S recognize that under some circumstances the "record-owner" cannot be treated as an owner for Subchapter S purposes because

[10] Section 1372(a) provides that an election is valid only if all persons who are shareholders in an electing corporation consent to the election at a specified time.

he is not the real party in interest. Treasury Regulation, section 1.1371–1(d)(1) provides in part that:

> * * * Persons for whom a [sic] stock in a corporation is held by a nominee, agent, guardian, or custodian will generally be considered shareholders of the corporation.

This regulation quite correctly reflects that Congress did not intend to impose an individual income tax on the owners of shares of Subchapter S corporations without their consent. To have done so would have directly contravened the enactment's policy of elective tax treatment. Nor did Congress intend to vest in nominees, guardians, agents or custodians the power to defeat an election by withholding their consent. See Treasury Regulation, section 1.1371–1(d)(1).

But, from this we cannot deduce that a trust can either qualify as a shareholder under section 1371(a) or be disregarded as the shareholder, because trusts, unlike nominees, guardians, agents and custodians, are recognized for tax reporting purposes. This is significant because we believe section 1371(a) addresses only entities recognized as taxpayers by the Code. Nominees, guardians, agents and custodians are not recognized as taxable entities and, hence, cases cited by taxpayer in which courts have ignored them and looked instead to the real parties in interest for Subchapter S consent purposes, are inapposite to the case at bar where we deal with a trust. Notwithstanding the provisions of the Code which define, modify and even eliminate a trust's obligation to pay taxes, the trust does remain a taxable entity of the kind addressed in section 1371(a) and cannot be ignored for qualification purposes by looking through it to the beneficiaries.[11]

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[11] We note here that in *A. & N. Furniture & Appliance Co.* v. *United States*, 271 F. Supp. 40 (S.D. Ohio 1967), a District Court held that subjecting shares of stock to a voting trust agreement did not terminate a Subchapter S election. This decision is not inconsistent with our position here. In that case a proprietor formed a corporation with the shares being issued to himself and his family members. The corporation filed a valid election for Subchapter S status. Subsequently, all the shareholders subjected their stock to a voting trust agreement with the father as trustee for the stated purpose of insuring continuity and stability of policy and management. The court found that under state law the creation of the voting trust gave the trustee no interest in the shares subject to the trust, nor did it give him the power to transfer ownership of the stock by sale or otherwise. It gave him merely the power to vote the shares. Indeed, the stock transfer records of the company still showed the individual family members as the owners of the stock. In essence, the court

III.

Taxpayer's third contention is that because Lemuel, as grantor of the Woods Trust, is taxed on the trust income under the "grantor trust rules" of section 671, *et seq.*, the trust should be ignored. The argument is that it would be inconsistent not to consider him the owner of the shares for Subchapter S eligibility purposes and yet tax him as their "owner" on the income they produce. Taxpayer, however, misconceives the manner in which the "grantor trust rules" operate. They do not, as taxpayer urges, recognize the grantor as the legal "owner" of the property placed in trust. On the contrary, the rules arose under the Code because it was recognized by Congress that taxation of income is not concerned so much with refinements of title as it is with actual command over the property taxed. *Corliss* v. *Bowers*, 281 U.S. 376 (1930). The "grantor trust rules" treat the grantor as if he were the owner in cases where he has reserved to himself some of the powers normally attendant to outright ownership. Thus, their design is to expand the coverage of the taxing statute. On the other hand, Subchapter S was enacted as a remedial measure to relieve qualifying small business corporations of a tax otherwise payable. Section 1371(a)(2) limits the benefits of the Act to corporations whose stock is owned solely by individuals or estates. Where such a deliberately specific qualification is imposed, we must strictly apply it lest the narrow benefit intended by Congress be unduly broadened. Hence, the "grantor trust rules," with the very purpose of expansion, and the qualification requirements of section 1371(a), with their restrictive purpose, are not analogous, and their comparison is not supportive of the taxpayer in this case.

Moreover, in making an argument based upon the applicability of the "grantor trust rules" taxpayer, in effect, concedes the existence and recognition of the Woods Trust

held that the "voting trust" was not truly a trust, but was more in the nature of an irrevocable proxy; it was not ownership of the shares of stock which was involved, it was merely voting rights which were affected.

The same result was reached in *Lafayette Distributors, Inc.* v. *United States*, 397 F. Supp. 719 (W.D. La. 1975), the reasoning of which, in part, we today reject insofar as it might suggest, *inter alia*, the appropriateness of the "beneficial owner test" in determining who the shareholder is for purposes of section 1371(a)(2).

for tax purposes because the rules themselves address taxation of trust income. If there were no trust for tax purposes, the rules would not apply. The applicability herein of the "grantor trust rules" embodied in section 671 *et seq.*, therefore, reinforces, rather than refutes, the argument that the Woods Trust must be recognized as the owner of taxpayer's stock.

IV.

Finally, the government relies on Treasury Regulations, section 1.1371–1(e) and section 1.1372–4(b)(3), which provide:

§ 1.1371–1 *Definition of small business corporation.*

* * * * *

(e) *Shareholders must be individuals or estates.* A corporation in which any shareholders is a corporation, trust, or partnership does not qualify as a small business corporation. The word "trust" as used in this paragraph includes all trusts subject to the provisions of subchapter D, F, H, or J (including subpart E thereof), chapter 1 of the Code and voting trusts. Thus, even though the grantor is treated as the owner of all or any part of a trust, the corporation in which such trust is a shareholder does not meet the qualifications of a small business corporation.

§ 1.1372–4 *Termination of election.*

* * * * *

(b) *Methods of Termination.*

* * * * *

(3) *Ceases to be small business corporation.* An election under section 1372(a) terminates if at any time after the first day of the first taxable year of the corporation for which the election is effective, or after the day on which the election is made (if such day is later than the first day of the taxable year), the corporation ceases to be a small business corporation as defined in section 1371(a). Thus, the election is terminated if an eleventh person, a non-resident alien, or a trust, partnership, or corporation becomes a shareholder, or if another class of stock is issued by the corporation. * * *

In *Lykes Bros. Steamship Co., Inc.* v. *United States*, 206 Ct. Cl. 354, 369, 513 F. 2d 1342, 1350 (1975), and *Birchenough* v. *United States*, 187 Ct. Cl. 702, 710, 410 F. 2d 1247, 1252

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(1969), we cited *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948), wherein the Supreme Court stated that it had:

> * * * many times declared that Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes and that they constitute contemporaneous constructions by those charged with administration of these statutes which should not be overruled except for weighty reasons. *See, e.g., Fawcus Machine Co.* v. *United States*, 282 U.S. 375, 378 [1931].

In light of what we have said in parts I, II and III of this opinion, it is our view that the above regulations correctly interpret Code section 1371(a)(2) to the extent that it prohibits an *inter vivos* revocable trust, such as the Woods Trust, from becoming a shareholder in a Subchapter S "small business corporation." In fact, section 1.1372–4(b)(3) precisely tracks the language of the Senate Committee Report on Subchapter S, quoted earlier, in stating "[t]hus, the election is terminated if * * * a trust becomes a shareholder * * *."

For the foregoing reasons, we are of the opinion that taxpayer is not entitled to recover. Therefore, defendant's motion for summary judgment is granted, and plaintiff's cross-motion for summary judgment is denied. The petition is dismissed.

THEODORE E. CHARLEY v. THE UNITED STATES

[No. 83–74. Decided December 17, 1975]

ON DEFENDANT'S AND PLAINTIFF'S MOTIONS FOR SUMMARY JUDGMENT

Civilian pay; adverse personnel action; Air Force Regulations; job performance requirements.—In 1968 plaintiff, a GS–13 engineer with the Air Force, was notified of his proposed removal for substandard job performance; he was offered a GS–9 position in lieu of removal; and following appeal the Hearing Office recommended plaintiff's reinstatement in his GS–13 position. Plaintiff subsequently filed grievance proceedings alleging management harass-

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ment; the Hearing Officer found that plaintiff had failed to sustain the charges; and plaintiff appealed to the Air Force Secretary. In February 1970 plaintiff was again notified of his proposed removal for substandard job performance on eight assigned projects; plaintiff denied the charges and on March 23, 1970 plaintiff was notified that the charges were fully supported by the evidence and warranted plaintiff's removal effective March 30, 1970. Following a series of administrative appeals the Air Force Secretary found that plaintiff's work performance was sufficiently substandard to warrant removal from his GS–13 position but that removal from service was not justified because management failed to consider him for reassignment or demotion as required by AFR 40–714, and also found that there was management hostility toward him but that this was not the essential cause of his substandard performance. The Secretary ordered the agency to offer plaintiff, in lieu of removal, reassignment or demotion to a position lower than GS–9 and to rectify management conduct. Plaintiff was offered and accepted a GS–9 position with retroactive pay at the GS–9 grade from March 30, 1970. In his suit plaintiff challenges the validity of the various administrative decisions, claiming violation of the requirements of AFR 40–714, that there were procedural errors in the hearing process, and that defendant erred in compensating him at the GS–9 level rather than at the GS–13 level. It is *held* (1) in light of the evidence presented, that defendant's offer of a GS–9 position following the Secretary's reinstatement order was neither arbitrary, capricious nor a violation of AFR 40–714, and plaintiff's claim in this regard is dismissed; (2) that the procedural errors respecting the Hearing Examiner's improper admission into evidence of four additional charges were harmless and had no effect on the ultimate decision, plaintiff having failed to show that he suffered actual harm or prejudice therefrom; and (3) that plaintiff is entitled to recover compensation at the GS–13 level from March 30, 1970 to the date of his reinstatement, and the case is referred to the Trial Division for determination of the amount of his recovery. The cross-motions are granted and denied consonant with the opinion, and the petition is otherwise dismissed.

Civilian pay; Court of Claims jurisdiction; administrative or executive decisions; review of by court.

[1] In review of adverse civilian personnel actions, this court's function is limited to the twin assessments of the procedural validity of the agency's action and the determination of whether substantial evidence supports that action.

Courts ⇐ 467

Civilian pay; Court of Claims jurisdiction; administrative or executive decisions; review of by court.

[2] In undertaking its limited review of adverse civilian personnel actions, the court is constrained to assess only the final decision of

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the agency with deference to the rulings of this court's prior decisions that it is not the court's function to substitute its judgment for that of the agency, but rather to review the case to determine whether the agency's action was reasonable in light of all the evidence or arbitrary and capricious.

Courts ⇐ 467

Civilian pay; presumptions; official actions of Government officials; presumption of regularity.

[3] The presumption in this court's review of adverse personnel actions is that Government officials act in good faith in performance of their duties.

Courts ⇐ 464(1)

Pleading and practice; special matters; particularity; arbitrariness.

[4] The mere allegation of the agency's arbitrary and capricious action, absent a direct and pointed attack on the evidentiary basis of the agency's action, is insufficient to warrant a judicial determination of wrongful agency action.

Administrative Law and Procedure ⇐ 725

Civilian pay; Court of Claims jurisdiction; administrative or executive decisions; review of by court.

[5] Although the Air Force Secretary determined that plaintiff had been subjected to management harassment, but concluded on the basis of the record before him that the harassment was not the essential cause of plaintiff's deficient work performance and that Air Force officials had provided plaintiff with adequate job assistance in compliance with AFR 40–714, since the findings of harassment and assistance are neither inconsistent nor mutually exclusive, and since plaintiff has failed either to convincingly develop the harassment finding or attack the assistance finding, the court will not substitute its judgment of the evidence for the Secretary's reasoned assessment of the same.

Armed Services ⇐ 27

Regulation of Executive Department; construction and operation; administrative interpretation.

[6] The agency Secretary's interpretation of its implementing regulations is entitled to credence as the expert administrative interpretation.

Administrative Law and Procedure ⇐ 413

Civilian pay; reduction in grade; reassignment or demotion; when appropriate; Air Force Regulations.

[7] Air Force Regulation 40–714 requires, *inter alia*, consideration of reassignment of an employee at his existing grade level prior to demotion when the employee fails to meet performance requirements of his position. Where the Air Force Secretary found that plaintiff's performance was sufficiently substandard to warrant removal from his highly technical GS–13 engineering position but that

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removal from the service was not justified, plaintiff's demotion in lieu of removal was reasonable, not arbitrary or capricious, and not in violation of AFR 40–714, where the record substantially evidences plaintiff's inability to perform in another GS–13 position.

Armed Services ⇐ 27

Civilian pay; dismissal; charges and reasons for dismissal; notice; additional charges introduced at hearing.

[8] Where plaintiff had notice of charges of alleged substandard performance justifying his proposed removal, and at the hearing the supervisor produced four additional charges, the withholding of the latter charges did not violate plaintiff's right to have notice of all charges on which the proposed action was based. As plaintiff had notice, opportunity to respond and the agency's decision was based only on those charges originally preferred against him, there was compliance with the notice requirements.

Armed Services ⇐ 27

Civilian pay; hearing; agency level hearing; evidence; error, harmless.

[9] To sustain a procedural error for improperly admitted evidence, plaintiff must show the actual harm or prejudice which he suffered as a result thereof. Thus, although the Hearing Examiner improperly admitted into evidence during plaintiff's removal hearing additional charges not specified in the original notice of charges, where the Hearing Examiner and the Air Force Secretary unequivocally and expressly disclaimed reliance upon the improperly admitted evidence in reaching their decision adverse to plaintiff, the error was harmless and did not vitiate the adverse personnel action complained of.

Armed Services ⇐ 27

Civilian pay; claim for back pay; entitlement to pay of higher position.

[10] When the Secretary invalidated plaintiff's removal from his GS–13 position for procedural violation and ordered plaintiff reassigned or demoted to a position no lower than GS–9 in accordance with AFR 40–714 this had the effect of restoring plaintiff to his GS–13 position and activated the Back Pay Act entitling plaintiff to retroactive pay from the date of his wrongful removal to the date of the reinstatement order.

Armed Services ⇐ 27

Herbert E. Fuller, for plaintiff. *Donald M. Murtha*, attorney of record. *McLellan, Thatcher, Murtha, Cafferky, Powers & Jordan*, of counsel.

Alan A. Ferber, with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Opinion of the Court

Before COWEN, *Chief Judge*, DURFEE, *Senior Judge*, and SKELTON, *Judge*.

DURFEE, *Senior Judge*, delivered the opinion of the court:

In this civilian pay case plaintiff challenges the actions of various Air Force decision-makers regarding adverse personnel actions against plaintiff. Plaintiff complains that the processes by which he was reduced in rank from grade GS–13 to grade GS–9 were arbitrary and capricious as not in compliance with various applicable personnel regulations and fraught with fatal procedural errors. By his petition and cross-motion for summary judgment, plaintiff seeks position restoration to grade GS–13, back pay and other relief. Defendant moves for summary judgment dismissing plaintiff's petition, maintaining that the Air Force complied with applicable personnel regulations in effecting plaintiff's demotion, and the same was not arbitrary, capricious, unsupported by substantial evidence, or procedurally defective.

Plaintiff, a non-veteran, entered Air Force service in 1962 as a civilian Aero space Engineer, grade GS–13, with the Air Force Systems Command, Mira Loma Air Force Station, California. In 1966 plaintiff was reassigned to the Sacramento Air Materiel Area, McClellan Air Force Base at the same grade GS–13 level following a reduction in force at his previous post. In January 1968 plaintiff's superiors, dissatisfied with plaintiff's performance of his assigned duties, issued plaintiff a warning letter notifying him of his substandard performance. This letter set out five areas in which plaintiff's supervisors found his performance inadequate. The letter contained the additional admonishment that plaintiff's failure to improve his performance would necessitate remedial action in the form of reassignment or removal. In July 1968 plaintiff's supervisors at McClellan, after careful review of plaintiff's work since the January warning letter, concluded that plaintiff had not made significant improvement in his performance, and issued plaintiff a notice of proposed removal. Following plaintiff's reply to this removal notice, his supervisors decided in August 1968 to offer plaintiff reassignment from his GS–13 position to a GS–9 position in lieu of removal. Plaintiff appealed this de-

motion action denying the inadequacy of his work, and charging his superiors with harassment. After hearing on the parties' charges the Hearing Officer concluded that neither party had substantiated its charges. The Hearing Officer recommended that plaintiff be reinstated in his former position, and in view of the obvious strained relations between plaintiff and his supervisors, that all efforts be made to laterally reassign plaintiff outside of the jurisdiction of his former supervisors. The Hearing Officer's decision was affirmed on review and plaintiff reinstated in his former GS–13 position.

Plaintiff subsequently pursued an intra-agency grievance procedure on his charges of management harassment. The Hearing Officer on this grievance proceeding found that plaintiff had failed to sustain his charges of supervisory harassment but recommended that continuing efforts be made to reassign plaintiff outside of his present supervisors. Plaintiff subsequently appealed this decision to the Secretary of the Air Force.

The strained relations between plaintiff and his supervisors, as previously found by two hearing officers, again came to a head in February 1970 when plaintiff's superiors again proposed to remove plaintiff for his failure to meet the performance requirements of his grade GS–13 position. This notice specified that the removal action was being proposed for plaintiff's substandard performance on eight of his fifteen assigned projects. Plaintiff responded in writing to the removal notice, categorically denying the performance inefficiency charges made in the Air Force's proposed removal notice and alleging that the proposed removal was in retaliation for plaintiff's submission of the above-mentioned grievance procedure against management. The Deputy Chief of plaintiff's division notified plaintiff on March 23, 1970, that after careful consideration of the information furnished in plaintiff's reply to his proposed removal, he had determined that the charges of plaintiff's substandard performance were fully supported by the evidence and warranted plaintiff's removal effective March 30, 1970.

Plaintiff elected to pursue an intra-agency appeal of the removal decision and requested a hearing. Following the

initiation of plaintiff's removal appeal, the Secretary of the Air Force determined that the record on plaintiff's aforementioned grievance procedure, then pending review in the Office of the Secretary, did not contain sufficient information to reach a firm conclusion on that matter and joined plaintiff's grievance complaint with his removal appeal for resolution of both issues.

At the hearing on plaintiff's removal, defendant introduced evidence of plaintiff's substandard performance on the eight projects specified in the Air Force's notice of proposed removal. In addition, defendant introduced evidence of plaintiff's inefficient performance on four additional assigned projects. The Hearing Examiner ruled that defendant's introduction of these four additional projects not detailed in the removal notice constituted error, but held it was not fatal to the proceeding as management did produce evidence on the eight original projects specified in the notice of proposed removal which plaintiff had the opportunity to contest.

In his decision, the Hearing Examiner pointedly excluded these four additional projects from consideration of the merits of the case. On consideration of the hearing record, excluding the four additional projects introduced by defendant for the first time at plaintiff's removal hearing, the Hearing Examiner found that management had failed to sustain its charges of plaintiff's inefficient work performance and that plaintiff had sustained his management harassment charge. Consequently, the Hearing Examiner recommended cancellation of the removal action and retroactive restoration of plaintiff to his grade GS–13 position. Additionally, the Hearing Examiner recommended that plaintiff not be assigned to a position under his former superiors.

On review of the Hearing Examiner's decision, the Vice Commander of the Sacramento Air Materiel Area declined to accept the Examiner's findings and recommendations. The Vice Commander, on consideration of the appellate record, concluded that plaintiff had not been harassed by his superiors and that the preponderance of the evidence fully supported management's charges of plaintiff's substandard performance and warranted his removal effective March 30, 1970.

Plaintiff requested review by the Secretary of the Air Force of the Sacramento Air Materiel Area Vice Commander's decision sustaining his removal. On August 3, 1971, the Secretary in a comprehensive and detailed decision amounting to *de novo* consideration of plaintiff's case, determined that:

> * * * appellant's work performance was sufficiently substandard to warrant his removal from the Mechanical Engineer, GS–13 position; but his removal from the service has not been justified because management failed to consider him for reassignment or demotion to other occupational fields as required by AFR 40–714. The decision finds also that appellant's supervisors had a hostile attitude toward him which adversely affected his performance, but that this was not the essential cause of his substandard performance. * * *.

In accordance with these findings, the Secretary ordered Sacramento Air Materiel Area officials to offer plaintiff, in lieu of removal, reassignment or demotion to a position no lower than GS–9 in accordance with AFR 40–714 and to rectify management supervision deficiencies.

As requested by the Secretary's decision, officials at the Sacramento Air Materiel Area offered plaintiff a GS–9 Equipment Specialist position with retroactive pay, at the GS–9 grade, from his March 30, 1970 removal date. Plaintiff accepted this offer and commenced employment in the grade GS–9 Equipment Specialist position on October 4, 1971.

On March 21, 1974, plaintiff commenced suit in this court, challenging the validity of the various Air Force decisions resulting in his demotion from grades GS–13 to GS–9. In all of his disputes with defendant, plaintiff was represented by counsel.

In review of adverse civilian personnel actions, the court's function is limited to the twin assessments of the procedural validity of the agency's action and the determination of whether substantial evidence supports that action. *Morelli* v. *United States*, 177 Ct. Cl. 848 (1966); *Boyle* v. *United States*, 207 Ct. Cl. 27, 515 F. 2d 1397 (1975); *Ricci* v. *United States*, 205 Ct. Cl. 687, 507 F. 2d 1390 (1974); *Grover* v. *United States*, 200 Ct. Cl. 337 (1973).

In undertaking this limited review of the agency's action, the court is constrained to assess only the final decision of the agency with deference to the rulings of our prior decisions that it is not the court's function to substitute our judgment for that of the agency, but rather to review the case to determine whether the agency's action was reasonable in light of all the evidence or arbitrary or capricious, *Boyle* v. *United States*, *supra*, 207 Ct. Cl. at 34, 515 F. 2d at 1401, *Harrington* v. *United States*, 174 Ct. Cl. 1110, 1117 (1966), and that Government officials presumably act in good faith in the performance of their duties. *Morelli* v. *United States*, *supra*; *Grover* v. *United States*, *supra*; *Greenway* v. *United States*, 75 Ct. Cl. 350, 362, *cert. denied*, 385 U.S. 881 (1966).

In seeking judicial review of the various proceedings culminating in his demotion, plaintiff claims only that the Air Force's personnel decisions were invalid for service's failure to comply with recognized due process requirements and certain applicable Air Force regulations. While plaintiff liberally charges defendant with arbitrary and capricious action, he makes no identifiable claims that either the facts found by the Air Force decision-makers were unsupported by substantial evidence or that defendant's actions were arbitrary and capricious other than defendant's alleged procedural failures to afford plaintiff the legel protections of law and certain Air Force regulations. The mere allegation of arbitrary and capricious action on defendant's part, absent a direct and pointed attack on the evidentiary basis of the agency's action, is insufficient to warrant a judicial determination of wrongful agency action. *Liotta* v. *United States*, 174 Ct. Cl. 91 (1966); *Mayer* v. *United States*, 145 Ct. Cl. 181 (1959). Hence, the court's review function in this case is limited to plaintiff's claims of procedural errors.[1]

The proper disposition of this case must focus on the final decision of the Secretary of the Air Force and whether that decision is predicated on or countenanced a procedural error

[1] Plaintiff expressly conceded in his petition (p. 2) that his claim rests solely on defendant's alleged procedural errors:

"4. This action arises on a claim founded on a breach of published regulations of the Department of the Air Force, * * * and the regulations issued by the Civil Service Commission * * *."

in effecting plaintiff's demotion. Plaintiff argues that his demotion stemming from that decision is invalid for (1) the Air Force's failure to follow certain of its regulations in effecting plaintiff's demotion and (2) procedural errors in the hearing process.

I. BREACH OF AGENCY REGULATIONS

Plaintiff contends that the Air Force's action in first proposing to remove plaintiff and then demoting him as of March 30, 1970 in lieu of removal, violated the requirements of Air Force Regulation 40–714 (AFR 40–714). AFR 40–714 outlines the measures that the service must take before considering removal of a civilian employee.[2] Essentially, the

[2] AFR 40–714 in pertinent part provides:

"1. Air Force Policy. Air Force supervisors and operating officials direct their efforts toward retaining employees who will promote the efficiency of the Air Force. Conversely, they reassign, reduce in grade, rank, or salary, or separate employees who do not meet Air Force standards. Actions must be taken promptly and equitably, and must comply with requirements and benefits provided by law and regulations.

"2. Guiding Principles:

"a. Each employee must know the performance requirements he is expected to meet for satisfactory performance in his position. (See AFR 40–451).

"b. When an employee fails to meet the performance requirements of his position, he must be told of his deficiencies and given an opportunity, with assistance, to improve before any adverse action is taken.

"c. Before separation action is taken, placement in other available positions in which the employee's performance can reasonably be expected to be satisfactory must be explored.

* * * * *

"4. Initial Action When Performance Fails to Meet Requirements:

"a. The employee must be advised of his shortcomings, given an opportunity to improve for a reasonable period, and assisted in meeting performance requirements as provided in AFR 40–451. He must also be told of the consequences if he fails to improve. Whenever possible, this information should be furnished in writing to insure that the employee understands the seriousness of the situation and what is expected of him. However, an oral discussion and warning is acceptable if a record of the discussion is made on the AF Form 971. 'Supervisor's Record of Employee.'

* * * * *

"5. Taking Corrective Action. If the employee's performance does not improve, the supervisor, in consultation with the civilian personnel office, determines whether reassignment, demotion, or separation is appropriate.

"*a. Considering the Employee for Other Positions.*

"Reassignment or demotion will be considered when the job requirements for the new position are sufficiently different from the old that the employee can reasonably be expected to meet them. Consideration is given first to available positions at the employee's current grade and then to those at lower grades."

* * * * *

regulation requires that an employee be given notice of his performance deficiencies and the opportunity to improve with the assistance of his supervisors. Further, the regulation requires that Air Force officials explore the possibilities of reassigning or demoting a deficient employee before considering removal. The regulation reflects the Air Force's policy that "Air Force supervisors and operating officials direct their efforts toward retaining employees who will promote the efficiency of the Air Force." [3]

Plaintiff asserts that his demotion was invalid because the Air Force denied him the benefits of AFR 40–714 both prior to the institution of the removal action and in the execution of that action. Specifically, plaintiff charges defendant with failure to provide plaintiff assistance in improving his job performance and failing to consider plaintiff for reassignment or demotion before initiating and executing the removal action. Plaintiff amplifies his claim of defendant's failure to render job assistance by charging that his supervisors rather than rendering assistance, as required by AFR 40–714, harassed plaintiff in the performance of his assignments.

On consideration of these charges by the Secretary of the Air Force, the Secretary found that plaintiff's supervisors did make adequate efforts under the circumstances to assist plaintiff to meet the performance standards of his position and that plaintiff's supervisors were also culpable of harassment, but that such was not the essential cause of plaintiff's performance deficiency. The Secretary, however, disregarded both of these points in reaching his ultimate determination. After extensive review of the merits of plaintiff's appeal, the Secretary concluded that while plaintiff's work performance was sufficiently substandard to warrant his removal, such action was not justified because of management's failure to consider plaintiff for reassignment or demotion to other positions consistent with the provisions of AFR 40–714. Accordingly, the Secretary terminated the removal action, subject to plaintiff's acceptance of reassignment or demotion in accord with AFR 40–714. Plaintiff subsequently accepted an offered grade GS–9 position retroactive to his March 30, 1970 date of removal.

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[3] AFR 40–714 ¶ 1, *supra*, n. 2.

The Secretary's detailed decision forecloses two of plaintiff's claims. The Secretary found that plaintiff was afforded adequate supervisory assistance in the performance of his assignments in accordance with AFR 40–714. This finding is adequately supported by the record, and well documented in defendant's brief. In fact, with the exception of the initial charge in his petition, plaintiff has failed to demonstrably pursue the point that he was denied supervisory assistance. In light of the Secretary's decision to the contrary, plaintiff's failure to demonstrate its fallability and the court's own review of the record, this part of plaintiff's claim is dismissed.

The Secretary agreed with plaintiff that he had been subject to management harassment. However, the Secretary went on to conclude that such harassment was not the essential cause of plaintiff's deficient work performance. The point of plaintiff's persistent claim of harassment in light of the Secretary's favorable finding on the issue is lost to the court. The court concurs with plaintiff's claim and the Secretary's finding of management harassment. What escapes the court is how concurrence in plaintiff's harassment claim entitles plaintiff to recovery. Plaintiff apparently equates management's harassment with its alleged failure to provide plaintiff with job assistance as required by AFR 40–714. Such an equation is not supported by the record. Only one of the hearing examiners who dealt with various phases of plaintiff's employment problems, and from whose decisions plaintiff liberally quotes in pressing his harassment claim, found that management's antagonistic attitude toward plaintiff extended to the denial of job assistance. The Secretary, on review, disagreed with this examiner's finding. The record amply supports the Secretary's contrary finding and plaintiff has failed to directly attack this finding. Even accepting plaintiff's harassment claim, the Secretary's concomitant finding that Air Force officials provided plaintiff with adequate job assistance in compliance with AFR 40–714 precludes plaintiff's unsupported argument that his supervisor's harassment included failure on their part to render job assistance, as required by AFR 40–714. These two findings are neither inconsistent nor mutually exclusive.

Rather, management's conduct, as found by the Secretary, included both harassment and adequate assistance to convince the Secretary of management's compliance with the requirements of AFR 40–714.

As the record adequately supports these twin findings, and plaintiff has failed either to convincingly develop the harassment finding or attack the assistance finding, the court will not substitute its judgment of the evidence for the Secretary's reasoned assessment of the same. *Harrington* v. *United States*, *supra; Guiness* v. *United States*, 149 Ct. Cl. 1, 6, *cert. denied*, 363 U.S. 819 (1960). Additionally, plaintiff has failed to point out authoritative interpretations of the extent of management assistance necessary to comply with the requirement of AFR 40–714 contrary to the Secretary's determination that plaintiff received such assistance in this case. Accordingly, the Secretary's interpretation is entitled to credence as the expert administrative interpretation of the regulation by the implementing agency. *Barrington Manor Apartments Corp.* v. *United States*, 198 Ct. Cl. 298, 304, 459 F. 2d 499, 502–03 (1972).

While the record supports a finding of management harassment, it equally supports a finding of management assistance to plaintiff. This latter finding vitiates plaintiff's claim that he has wrongfully been subject to an adverse personnel action contrary to the applicable regulation. Plaintiff is not entitled to recover only upon substantiation of supervisory harassment. In order to establish a violation of AFR 40–714, entitling plaintiff to recovery, plaintiff must show that such supervisory harassment included a denial of management assistance. This plaintiff has not shown and accordingly this part of plaintiff's petition must likewise be dismissed.

Finally, plaintiff argues that the offer of a grade GS–9 position by personnel officials at McClellan Air Force Base following the Secretary's order that plaintiff be reassigned or demoted, violated the provisions of AFR 40–714. Plaintiff contends that after the Secretary's reinstatement order, Air Force personnel officials were bound by the regulation to consider plaintiff for a grade GS–13 position, and that their alleged failure to do so was violative of AFR 40–714.

Plaintiff points out that the Secretary's reinstatement order did not require plaintiff's demotion and that the order only directed personnel officials to consider plaintiff for reassignment or demotion in accordance with the provisions of AFR 40–714. Further, plaintiff correctly asserts that AFR 40–714 requires consideration of reassignment of an employee at his existing grade level prior to demotion.[4] Hence, plaintiff argues that defendant's offer of a grade GS–9 position was not in accordance with the requirements of AFR 40–714, and invalidates the demotion action.

While plaintiff is correct in all of his assertions as to the requirements of both the Secretary's reinstatement order and the applicable regulations, he fails to reconcile these requirements with the facts of the case. After review of the proper evidence in the record, the Secretary found that plaintiff's "performance was sufficiently substandard to warrant his removal from the Mechanical Engineer, GS–13 position * * *." This finding expressly represents the judgment of the highest official of the Air Force that plaintiff was unqualified for service in the Air Force as a grade GS–13 engineer. Air Force grade GS–13 engineers are independently responsible for the solution of complex technical engineering problems involving substantial Air Force investments in equipment as well as the lives of service personnel. The performance standard for grade GS–13 engineers is 98% error-free work without technical supervision. Plaintiff's performance was well below this standard. In view of the highly technical nature of the work of Air Force grade GS–13 engineers, the substantial and independent responsibility entrusted to them, and the Secretary's judgment as to plaintiff's inability to perform such work, plaintiff's demotion from his prior grade GS–13 engineering position is not at all unreasonable, arbitrary or capricious.

The record adequately evidences plaintiff's inability to perform the duties of a grade GS–13 engineering position. As such, reassignment of plaintiff to another grade GS–13 position would be both contrary to the evidence and possibly jeopardize Air Force equipment, projects and personnel.

[4] AFR 40–714 ¶5.a., *supra*, n. 2.

Plaintiff's claim that he should have been considered for reassignment to another grade GS–13 engineering position is voided by the substantial evidence in the record. Defendant's presentation by way of exhibits and affidavits convinces us that reasonable steps were taken to reinstate plaintiff in a suitable position for which he was qualified. In light of the evidence presented in this case, we find that defendant's offer to plaintiff of a GS–9 position following the Secretary's reinstatement order to be neither arbitrary, capricious nor a violation of AFR 40–714 and plaintiff's claim in this regard is dismissed.

II. PROCEDURAL ERRORS IN THE HEARING PROCESS

Plaintiff claims that the defendant committed two fatal procedural errors in the hearing process which invalidate the entire personnel action and entitle plaintiff to retroactive status and back pay as a grade GS–13 as of his March 30, 1970 removal date. Plaintiff contends that when his supervisor set forth only eight charges of plaintiff's performance deficiencies in his letter of charges, but produced an additional four charges at the hearing, the supervisor failed to notify plaintiff of all charges which the supervisor considered in reaching his decision to remove plaintiff. Plaintiff argues that his supervisor's withholding of the four additional charges until the hearing, violated plaintiff's right to have notice of all charges on which the adverse personnel action is based. Plaintiff did not raise this point in his pleadings before the court and has provided no authority for this proposition.

The notice requirement contained in various applicable statutes and Air Force regulations extends to an employee only the right to have notice of the charges on which the agency relies in proposing its adverse personnel action and upon which the agency seeks to have such action legally validated.

As plaintiff had notice, opportunity to respond and the agency's decision was based only on those charges originally preferred against plaintiff in the agency's letter of charges, defendant complied with the notice requirements of both applicable statutes and regulations and this late-raised argu-

ment of plaintiff is dismissed. *O'Brien* v. *United States*, 151 Ct. Cl. 392, 284 F. 2d 692 (1960).

The second fatal error which plaintiff contends defendant committed during the hearing process was the Hearing Examiner's admission into the record of the four additional charges not specified in the original letter of charges. Plaintiff argues that the admission into the record of these extra adverse charges against plaintiff was improper because they had not been specified in the letter of charges. On this point the Hearing Examiner, the Secretary of the Air Force and the court agree. Plaintiff goes on to contend, however, that the mere presence of the four additional charges in the record irrevocably prejudiced plaintiff's case on review both before the Vice Commander of the Sacramento Air Materiel Area and the Secretary of the Air Force, even though both of these reviewers disclaimed reliance on this evidence in reaching their decisions. On this point the court disagrees. Our decision in *Haynes* v. *United States*, 190 Ct. Cl. 9, 418 F. 2d 1380 (1969), forecloses plaintiff's argument on this point.

In *Haynes*, the court was faced with a civilian pay case where undoubtedly improper evidence was also admitted into the hearing record. On consideration of whether the presence in the record of this improperly admitted evidence necessitated reversal of the agency personnel action for procedural error the court ruled that plaintiff's claim "must fail because the error * * * was harmless and had no effect on the ultimate decision." *Haynes* v. *United States*, *supra*, 190 Ct. Cl. at 15, 418 F. 2d at 1384. Likewise, the instant plaintiff's identical claim must fail for the same reason.

To sustain a procedural error for improperly admitted evidence, plaintiff must show the actual harm or prejudice which he suffered as a result of the admission of the improper evidence. "He must show that this piece of evidence was relied upon to his detriment." *Haynes* v. *United States*, *supra*, 190 Ct. Cl. at 14, 418 F. 2d at 1384. Plaintiff, in this case, cannot meet this burden because both the Hearing Examiner and the Secretary unequivocally and expressly disclaimed reliance upon the improperly admitted evidence in reaching their decisions.

The Vice Commander of the Sacramento Air Materiel Area's decision on review of plaintiff's case is equivocal on the point of whether he considered the four improper charges. However, even if he did, and we believe he did not, that defect, if any, was corrected by the Secretary's final decision which expressly excluded the four improper charges from consideration of the merits of plaintiff's case. In this regard, we note that the Secretary predicated his decision on an extensive and detailed examination of the case amounting to *de novo* review. The Secretary did not merely affirm the Vice Commander's decision.

As plaintiff cannot show that these four improperly admitted charges were relied upon by the Air Force decision-makers to his detriment and the record undisputably shows that this improper evidence had no effect on the ultimate decision, this part of plaintiff's claim must fail because the error was harmless. *Haynes* v. *United States*, *supra*, *cf. McDonald* v. *United States*, 205 Ct. Cl. 780, 507 F. 2d 1271 (1974).

The parties' failure to delineate and develop precise legal issues in this appeal has resulted in the presentation to the court of an unnecessarily convoluted and largely unconnected assortment of questions. This failing has necessitated some restructuring of the parties' arguments and redundancy in the court's opinion. In reviewing this case the court has thoroughly considered all of the parties' arguments but has addressed only those, which in the court's opinion, were legally significant.

One further issue remains to be considered. This is whether following the Secretary's termination of plaintiff's removal action and his reinstatement order, defendant erred in retroactively demoting plaintiff to GS–9 and compensating him at that grade level from the date of his removal to the date of his reinstatement. We believe defendant did so err. When the Secretary invalidated plaintiff's removal for the Air Force's failure to follow its own regulations and ordered plaintiff reassigned or demoted in accordance with the provisions of AFR 40–714, he also at the same time abrogated the Air Force's power to retroactively sanction plaintiff in any

way on account of the adverse personnel proceeding he had invalidated. The Secretary's cancellation of the service's previously executed removal action had the effect of restoring plaintiff to his former grade GS–13 position. In fact, the first employment form issued to plaintiff upon his return to the Air Force listed his position as a grade GS–13, and carried the notation "Retroactive restoration after appeal to agency. * * * Entitled to back pay under 5 USC 5596." 5 U.S.C. § 5596, the Back Pay Act, provides that:

> (b) An employee of an agency who, on the basis of an administrative determination of a timely appeal, is found by appropriate authority under applicable law or regulation to have undergone an unjustified or unwarranted personnel action that has resulted in the withdrawal or reduction of all or a part of the pay, allowances, or differentials of the employee—
>
> (1) is entitled, on correction of the personnel action, to receive for the period for which the personnel action was in effect an amount equal to all or any part of the pay, allowances, or differentials as applicable, that the employee normally would have earned during that period if the personnel action had not occurred, less any amounts earned by him through other employment during that period; * * *.

* * * * *

The Secretary's decision that plaintiff's removal from the service had not been justified, effectively restored plaintiff to his former grade GS–13 position, activated the Back Pay Act, and entitled plaintiff to recovery in accordance with that statute.

Accordingly, plaintiff is entitled to recover back pay at the grade GS–13 level less the grade GS–9 pay he has received and other statutory adjustments from the date of his removal to the date of his reinstatement. On this one issue, plaintiff's cross-motion for summary judgment is granted, and defendant's motion for summary judgment is denied, and the case referred to the Trial Division for further proceedings under Rule 131(c). As to all other issues plaintiff is not entitled to recover, and defendant's motion for summary judgment is granted, plaintiff's cross-motion is denied, and his petition is dismissed.

Syllabus

534 F. 2d 237

FRANCIS SKROBOT V. THE UNITED STATES

[No. 338–74. Decided December 17, 1975. Plaintiff's motion for rehearing denied January 30, 1976]

ON PLAINTIFF'S AND DEFENDANT'S MOTIONS FOR SUMMARY JUDGMENT

Civilian pay; promotion; noncompetitive promotion; reduction in rank; opportunity to compete; "career" promotion.—Plaintiff served as Assistant Chief, Production Division, GS–13, in the Defense Supply Agency from 1968 to 1972. He requested an audit of his position, asserting that he was performing GS–14 work, including an added "post award function"; the agency did not conduct the audit. In July 1972 the agency abolished plaintiff's position and reassigned him to another GS–13 position. It then created a new GS–14 post encompassing duties similar to those plaintiff had been performing, and filled the new position with a GS–14 assigned in connection with a reduction-in-force. Administrative grievance proceedings ultimately resulted in a determination by the CSC Board of Appeals and Review (BAR) that plaintiff was not entitled to a noncompetitive promotion to the new position. Plaintiff contends here that he had a legal right to a noncompetitive promotion and that the BAR's denial was arbitrary and capricious; that his lateral reassignment was equivalent to a reduction in rank; that he was erroneously denied an opportunity to compete for the GS–14 position; and that he was entitled to a "career" promotion. On review of the applicable provisions of the Federal Personnel Manual, it is *held* (1) that plaintiff has no legal right to promotion because he has not brought his situation under the "no duty change" and "classification error" requirements of Subch. 4–3b, Ch. 335 of the Manual, that the agency's reclassification delay did not bestow any legal rights upon him, and that the BAR's decision to deny him noncompetitive promotion was proper; (2) that plaintiff's reduction-in-rank assertion is similarly unpersuasive and is rejected; (3) that the action of the agency in not giving plaintiff an opportunity to compete for the GS–14 position was in compliance with 5 U.S.C. § 3502 (1970); and (4) that the record fails to demonstrate agency abuse of discretion in not according plaintiff a noncompetitive "career" promotion. Plaintiff's motion for summary judgment is denied, defendant's cross-motion is granted, and the petition is dismissed.

Civilian pay; promotions; selection for promotion; agency discretion. [1] The Court of Claims may not grant promotions where the exercise of such power would result in substituting the court's judgment for executive agency discretion.

United States ⇐ 36

Syllabus

Civilian pay; promotions; Court of Claims jurisdiction.

[2] This court's power, if any, to grant promotions and corresponding back pay hinges upon a Government employee's legal entitlement to such a remedy based upon a statute or regulation.

Courts ⇐ 449(1)

Civilian pay; appointment and tenure; generally.

[3] Absent a legal right to promotion, a Government employee may not obtain a higher position or salary incident thereto since his rights and salary are based solely on the position to which he has been legally appointed.

United States ⇐ 36

Civilian pay; promotions; noncompetitive promotion.

[4] Under the guidelines of Subch. 4–3b, Ch. 335, of the Federal Personnel Manual (1973), it is mandatory that the employing agency provide for an exception to competitive promotion if the employee meets legal and qualification requirements for the higher grade. To obtain the benefits of the exception, the employee must demonstrate that the agency upgraded his position without significant change in duties and responsibilities and that the elevation resulted from either issuance of a new classification standard or correction of a classification error.

United States ⇐ 36

Civilian pay; promotions; noncompetitive promotion; "no duty change".

[5] The "no duty change" clause of Subch. 4–3b, Ch. 335, Federal Personnel Manual (1973), must be read narrowly to avoid irreparable damage to the Government competitive promotion policy upon which the merit system is based. The "no duty change" language refers to job descriptions, rather than to actual duties performed.

Officers ⇐ 11.7

Civilian pay; promotion; noncompetitive promotion; "classification error".

[6] Based on the same policy considerations relating to the "no duty change" clause of Subch. 4–3b, the "classification error" language of 4–3b is confined to situations where the official responsible for classifying the position has erred, and does not apply to instances where actual duties performed do not match job descriptions because the agency has added or taken away responsibilities in the course of day-to-day work.

Officers ⇐ 11.7

Civilian pay; promotions; noncompetitive promotion; delay in desk audit.

[7] The fact that an employee's requested desk audit was delayed, despite the requirement for an annual review of positions under Subch. 4–3, Ch. 312, Federal Personnel Manual (1973), gave the

Syllabus

employee no vested right to a noncompetitive promotion absent statute or regulation calling for such promotion as a result of the delay.

United States ⇐ 36

Civilian pay; reduction-in-rank; what constitutes.

[8] A lateral assignment to a substitute position at the same grade is not a reduction-in-rank where the employee's former position has been upgraded as the result of addition of a function involving a significant change in job content and where no reviewing official has made a classification error in evaluating the employee's former position.

United States ⇐ 36

Civilian pay; reduction in force; retention preference; opportunity to compete.

[9] Since the noncompetitive filling of a position upgraded to GS–14 with one other than the former incumbent of the GS–13 position was in compliance with the reduction in force statute 5 U.S.C. § 3502, the agency's action in not affording the former incumbent an opportunity to compete was proper. Had said former incumbent been afforded the opportunity to compete, it is conjectural whether he would have been successful among the numerous applicants; accordingly a request that the court find that the former incumbent would have gained the position will not be entertained. Courts do not engage in speculation.

United States ⇐ 36

Civilian pay; promotion; "career" promotion; newly created position.

[10] Under Subch. 4–2d, Ch. 335, Federal Personnel Manual (1973), a "career" promotion of an employee whose position is reconstituted in a higher grade is permissive or discretionary within the guidelines set forth. Where the record fails to demonstrate that the conduct of the agency in declining to grant a "career" promotion to plaintiff was so clearly wrong as to be arbitrary, the court cannot substitute its judgment for agency discretion.

United States ⇐ 36

James R. Rosa, Staff Counsel, *American Federation of Government Employees, AFL–CIO*, attorney of record for plaintiff. *L. M. Pellerzi*, General Counsel, *American Federation of Government Employees, AFL–CIO*, of counsel.

Marc J. Fink, with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Before DAVIS, NICHOLS, and KUNZIG, *Judges*.

KUNZIG, *Judge*, delivered the opinion of the court.

In this civilian pay suit, plaintiff, a Defense Supply Agency (Agency) employee, asks the court to reverse a ruling by the Civil Service Commission Board of Appeals and Review (BAR) denying his request for promotion from GS–13 to GS–14 and corresponding back pay. Plaintiff had urged that the assignment of temporary additional work entitled him to the higher position. Because we hold that plaintiff fails to demonstrate a legal right to promotion and that the BAR's decision was in no way arbitrary and capricious, we conclude that plaintiff is not entitled to recover.

The relevant facts are stipulated. Plaintiff is a nonprobationary civil servant with tenure and veterans preference rights who served as Assistant Chief, Production Division (GS–13) from 1968 until 1972. In November 1970, the Agency, then in the process of an extensive reorganization, added a "post award function" [1] to plaintiff's work. Plaintiff subsequently requested an audit of his position, asserting that he was performing GS–14 work. The Agency failed to perform the audit. On July 30, 1972, the Agency abolished plaintiff's Assistant Chief position and reassigned him to another GS–13 job. The Agency then created a new GS–14 post encompassing duties similar to work performed by plaintiff from November 1970 to July 1972. It filled this new position with a GS–14 assigned in connection with a reduction in force.

Plaintiff instituted a grievance proceeding, asserting that his GS–13 position (including the added work) had been upgraded to GS–14 without a significant change in duties and responsibilities to correct a classification error and sought noncompetitive promotion based on Chapter 335, Subchapter 4–3b, Federal Personnel Manual (FPM). The Civil Service Commission (CSC) hearing examiner agreed with plaintiff, but the Agency refused to accept this conclusion.[2]

Plaintiff appealed to the CSC Regional Director who also found in favor of plaintiff. This time the defendant appealed.

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[1] Plaintiff has not defined the exact nature of this post award function.

[2] Under 5 C.F.R. § 771.310 (1972), the applicable grievance regulation in effect at the time of plaintiff's hearing, the Agency was not required to accept the recommendations of the hearing examiner.

The BAR reversed the Regional Director and concluded that plaintiff was not entitled to a noncompetitive promotion to the new GS–14 position. Following this reversal, plaintiff instituted the present action.

Plaintiff attacks the BAR's decision on four fronts arguing that: I. Plaintiff had a legal right to a noncompetitive promotion and BAR's denial was arbitrary and capricious; II. Plaintiff's lateral reassignment to the substitute GS–13 position was the equivalent of a reduction-in-rank. III. Plaintiff was erroneously denied an opportunity to compete for the GS–14 position; and IV. Plaintiff was entitled to a "career" promotion. We reject each of these contentions.

I. NONCOMPETITIVE PROMOTION

Plaintiff's key argument is that he has a legal right to a noncompetitive promotion under subchapter 4–3b.[3] According to plaintiff, this portion of the FPM applies to his situation because the new GS–14 position provided for no significant change in duties and responsibilities and the Agency created it to correct a classification error in the Assistant Chief position. Plaintiff argues that he is legally entitled to a promotion and that the BAR's failure so to find was arbitrary and capricious. Defendant counters that the new GS–14 position provided for a significant change in job descriptions and, therefore, a significant change in duties and responsibilities. The BAR agreed with defendant's position. We concur.

We start with the premise that the Court of Claims may not grant promotions where the exercise of such power would result in substitution of the court's judgment for executive agency discretion. *Hirsch* v. *United States*, 205 Ct. Cl. 256, 260, 499 F. 2d 1248, 1250 (1974); *Wienberg* v. *United States*,

[3] Chapter 335, Subchapter 4–3b, FPM (1973) in effect at the time of the events in this action provides:

"Promotion to positions upgraded without significant change in duties and responsibilities. An agency *must* provide for an exception to competitive promotion procedures to allow for the promotion of an incumbent of a position which has been *upgraded without significant change in duties and responsibilities* on the basis of either the issuance of a new classification standard or the correction of a classification error. If the incumbent meets the legal and qualification requirements for the higher grade, he *must be promoted* noncompetitively unless removed from the position by appropriate personnel action." (emphasis added).

192 Ct. Cl. 24, 35, 425 F. 2d 1244, 1251 (1970); *Tierney* v. *United States*, 168 Ct. Cl. 77, 80 (1964). Our power, if any, to grant promotions and corresponding back pay hinges upon a party's legal entitlement to such a remedy based upon a statute or regulation. *Selman* v. *United States*, 204 Ct. Cl. 675, 498 F. 2d 1354 (1974); *Doggett* v. *United States*, 207 Ct. Cl. 478 (1975).[4] Absent a legal right to promotion, an employee may not obtain a higher position or the salary incident thereto since his "rights and salary are based solely on the position to which he has been legally appointed." *Bielec* v. *United States*, 197 Ct. Cl. 550, 560, 456 F. 2d 690, 696 (1972). *See also Desmond* v. *United States*, 201 Ct. Cl. 507, 525–526 (1973); *Dianish* v. *United States*, 183 Ct. Cl. 702, 707 (1968). Plaintiff contends that subchapter 4–3b provides the basis for a legal entitlement in his case and that we, therefore, have the power to promote him.

We agree that subchapter 4–3b may, in a proper case, create a legal entitlement to promotion. It is clearly cast in *mandatory*, not permissive, form: "An agency *must* provide for an exception to competitive promotion * * *. If the incumbent meets the legal and qualification requirements for the higher grade he *must* be *promoted* noncompetitively * * *." (emphasis added). There is no room for agency discretion here. If the guidelines of 4–3b are met, an employee establishes a legal right to a promotion. However, it is at this point that our agreement with plaintiff ends for we find that plaintiff has been unable to bring his situation within the confines of 4–3b.

Before an employee may obtain the benefits of subchapter 4–3b he must demonstrate that two conditions exist. First, the agency must have upgraded the position "without [a] significant change in duties and responsibilities." Second, the elevation must have resulted from "either the issuance of a new classification standard or the correction of a classification error." As we interpret these two conditions, plaintiff cannot demonstrate that they arise in this case and, therefore, fails to present a clear legal entitlement to promotion.

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[4] *See also Peters* v. *United States*, *ante* at 373, 534 F. 2d 232 (1975).

Opinion of the Court

(1) "No duty change"

The "no duty change" clause of subchapter 4–3b poses our first question for interpretation. Does this phrase require no change in duties and responsibilities of work *actually performed*, or does it relate to no alteration of duties and responsibilities embodied in the employee's *job description*? We prefer the latter interpretation.

Construction of the "no duty change" language presents us with an uncomfortable dilemma. On one hand, we recognize that to compare old and new job descriptions to some extent exalts form over substance and may unfairly deny a promotion to a deserving employee who has diligently performed work above and beyond the call of his job description. However, the alternative is even more unpalatable. Thousands of government employees perform functions not formally established by their job descriptions. Indeed, in many instances, jobs grow gradually over the years, not through planned additions to duties, but because the exigencies of the moment require employees to assume added tasks. For us to read the "no duty change" of subchapter 4–3b as applying to duties *actually performed* would raise the specter of a massive volume of constant civilian pay litigation and administrative chaos from thousands of grievance hearings.

Moreover, subchapter 4–3b creates an *exception* to the general policy of competitive promotion in the government civil service merit system. If we are to avoid irreparable damage to this fundamental principle upon which the merit system is based, we must read such an exception narrowly. Therefore, we conclude that the "no duty change" language of subchapter 4–3b refers to job descriptions, rather than to actual duties performed.

In this fact situation, it is quite clear that there was a significant change in the specific job descriptions involved. Plaintiff's old Assistant Chief job description did not contain the "post award" function embodied in the new GS–14 job description. Plaintiff thus cannot bring his case within subchapter 4–3b and fails under point (1) to establish a legal entitlement to promotion.

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(2) "Classification error"

Even if we found no significant change in duties and responsibilities, we would be compelled to reject plaintiff's 4–3b contentions based upon failure of the second condition, the "correction of a classification error" clause.[5] *Both* conditions must obtain before an employee may enjoy the benefits of 4–3b. Plaintiff's argument is that the new GS–14 position was created to correct the erroneous classification of the GS–13 Assistant Chief position. Again, our consideration of 4–3b evolves into a question of interpretation. This time we must determine the meaning of "classification error" and apply it to the facts of plaintiff's case.

For the same policy considerations[6] that compelled us to read the "no duty change" clause of subchapter 4–3b narrowly, we are forced to give a similar narrow construction to the "classification error" language. We construe the term "classification error" as limited to errors in the classification *process*. It does not apply to instances where actual duties performed do not match job descriptions because the agency has added or taken away responsibilities in the course of day to day work. In other words, we confine "classification error" to the situation where the official responsible for classifying the position has erred. Otherwise we would put this court in the position of holding that thousands of employees engaged in daily tasks differing only in minute detail from their job descriptions are the victims of classification errors. Such a decision would drive the civil service system to its knees under the burden of a multitude of grievances filed by "erroneously classified" employees and would grant countless noncompetitive promotions. We decline to create such a situation.

In the instant case, plaintiff neither alleges nor attempts to prove that an evaluator made an error in classifying the old Assistant Chief job description. Therefore, we conclude

[5] The upgraded position must result from either the issuance of a new classification standard or the result of a classification error. *See* note 3, *supra*. Plaintiff does not assert and there is no indication that any new classification standards were issued here.

[6] Administrative chaos created by a massive volume of constant litigation coupled with the need to protect the fundamental principles of the civil service merit system.

that plaintiff has failed to demonstrate "classification error" (point (2)) as well as "no duty change" (point (1)) and cannot avail himself of the noncompetitive promotion provisions of subchapter 4–3b. The BAR did not err by finding 4–3b inapplicable to the facts of plaintiff's case.

Moreover, the fact that plaintiff requested an audit of his job and that the audit was delayed in spite of requirements to the contrary [7] gives plaintiff no vested right to a promotion where 4–3b is inapplicable. The Agency's failure to comply with the annual review requirements did not grant any legal right to a promotion for plaintiff, nor did it subject the Agency to the outlandish liability of allocating vested promotion rights outside the normal competitive merit system to employees whose jobs were merely not reviewed on time. Further, we cannot say that a few months' delay beyond the end of the annual period is particularly unreasonable where the Agency is admittedly in the process of an ongoing major reorganization, presumably as the result of cutbacks in the Vietnam war effort. Thus the delay itself did not in any way grant plaintiff a right to a noncompetitive promotion where no statute or regulation calls for such promotion as a result of the delay.

To summarize, we hold that plaintiff has no legal right to promotion because he has not brought his situation under the (1) "no duty change" and (2) "classification error" requirements of subchapter 4–3b and also because the Agency's reclassification delay did not bestow any legal rights upon him. We, therefore, uphold the BAR's decision to deny plaintiff's noncompetitive promotion.

II. REDUCTION-IN-RANK

Plaintiff's second argument, that he was improperly reduced in rank by virtue of his lateral reassignment to the substitute GS–13 position, is based on a regulation with the same conditions as those found in 4–3b (discussed in Part I, *supra*).[8] Plaintiff's reduction-in-rank contention relies on the

[7] Chapter 312, subchapter 4–3. Federal Personnel Manual (1973), in conjunction with the Supplemental Appropriation Act of 1952, as amended (revision note to 5 U.S.C. § 3101 (1970)) required annual review of positions "to assure that the position description is accurate and classification is proper."

[8] Indeed, the FPM cross-references the two regulations.

provisions of Supplement 752–1, Subchapter S1–4, Paragraph b(2), FPM (1973).[9] It merely considers the identical situation from a different angle.[10] Since there was a significant change in the job description of plaintiff's position after the addition of the "post award function" and since no reviewing official made a classification error in evaluating plaintiff's Assistant Chief position, we reject plaintiff's reduction-in-rank assertion for the same reasons that we rejected his right to promotion argument and therefore uphold the decision of the BAR.

III. OPPORTUNITY TO COMPETE

Plaintiff's third contention is that the Agency improperly denied him an opportunity to compete for the new GS–14 position. We begin with the proposition that the Agency filled the newly created GS–14 position noncompetitively in compliance with the reduction in force (RIF) statute. 5 U.S.C. § 3502 (1970). There is nothing in the record which indicates that this action was anything but proper. Further, even if plaintiff lost an opportunity to compete for the GS–14 position, we cannot, at this late date, indulge in conjecture over his chances to win the competition. Plaintiff, in effect, asks the court to find that he probably would have gained the position had he been given an opportunity to compete. We must decline plaintiff's invitation to gaze into a crystal ball. Hundreds of more qualified applicants might well have contested his aspirations. It is axiomatic that courts do not engage in speculation. *Cf.*, *Palmer* v. *United States*, 206 Ct. Cl. 851, 852 (1975). Moreover, plaintiff does not specifically ask for a present opportunity to compete, but demands an in-

[9] Supplement 752–1, Subchapter S1–4, Paragraph b(2) FPM (1973) provides in part:

"* * * The incumbent of a position is entitled to promotion to the grade determined appropriate for the work he has been performing, if he is eligible for promotion in two specific circumstances: * * * (ii) when *error in classification* has deprived him of the proper grade. (When there is a *significant change in job content* see (S1–4, c(1)) [reduction in rank inapplicable]. His assignment to a position in a grade below the proper grade of his position is a reduction in rank whether or not the upgrading decision has been put into effect by official classification action at the time of the assignment * * *." (emphasis added).

[10] 4–3b analyzes the personnel action from the view of a right to promotion while SI–4, b(2) contemplates the same situation from the right not to be reduced in rank.

stantaneous noncompetitive promotion.[11] We hold under the appropriate RIF statute that plaintiff was not erroneously denied an opportunity to compete. Alternatively, if by any stretch of the imagination he were so denied, a lost opportunity to compete creates no legal rights for which we can fashion a remedy in this case.

IV. CAREER PROMOTION

Plaintiff's final argument is that he was entitled to a noncompetitive "career promotion" by virtue of Chapter 335, Subchapter 4–2d, FPM (1973).[12] Like subchapter 4–3b (mandatory right to promotion) and S1–4, b(2) (reduction-in-rank), subchapter 4–2d (career promotion) contains two main conditions. They are somewhat different from those discussed above. First, the newly created position must be the result of "accretion of additional duties." Second, the accretion must not have been the result of planned management action. However, the crucial difference between 4–2d and 4–3b is that career promotions (4–2d) are *permissive or discretionary* in nature rather than mandatory (as in 4–3b). "An agency *may* make a career promotion."[13] Plaintiff readily concedes this, but argues, given the equities of his case, the Agency "could and should * * * have granted plaintiff a noncompetitive career promotion." Whatever the force of plaintiff's equitable argument, the court cannot substitute its judgment for agency discretion. *Hirsch, supra; Wienberg, supra; Tierney, supra.* The Agency has exercised this discretion by declining to grant a career promotion (4–2d) to plaintiff. We may not override this decision unless

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[11] Defendant argues that having failed to assert the lost opportunity to compete issue at the BAR, plaintiff is precluded from raising it for the first time at this court. *Haynes* v. *United States*, 190 Ct. Cl. 9, 12–13, 418 F. 2d 1380, 1382–83 (1969). Plaintiff counters that he was trapped into this situation by the CSC Regional Director's removal of the issue from the case and plaintiff's failure to urge it at the BAR was, therefore, excusable and should not preclude assertion before the Court of Claims. Since we reject plaintiff's competition argument on other grounds, we need not reach the exhaustion problem.

[12] Subchapter 4–2d provides in part:

"*Career promotion of an employee whose position is reconstituted in a higher grade.* An agency may make a career promotion of an employee whose position and responsibilities if the accretion was *not the result of planned management* is reconstituted in a higher grade because of the *accretion of additional duties action.*" (emphasis added).

[13] *Id.*

there has been a clear abuse of discretion. *Drucker* v. *United States*, 204 Ct. Cl. 514, 498 F. 2d 1350 (1974). As we stated in *Drucker*, the proper standard for review of agency conduct is action "so clearly wrong as to be arbitrary." *Drucker*, *supra*, 204 Ct. Cl. at 518, 498 F. 2d at 1352. The record fails to demonstrate any such abuse of discretion in this case and we therefore uphold the decision below not to grant plaintiff a career promotion.[14]

In summary, we have considered and rejected plaintiff's promotion and backpay claims based upon legal right to promotion, improper reduction-in-rank, lost opportunity to compete and "career promotion." Moreover, were the court to grant a noncompetitive promotion on the facts herein, such decision could spur a massive volume of constant litigation resulting in administrative chaos and would be destructive of the fundamental principle of civil service—the competitive merit system. Therefore, we hold that the decision of the BAR was legally correct and was in no way arbitrary and capricious.

Accordingly, plaintiff's motion for summary judgment is denied, defendant's motion for summary judgment is granted, and plaintiff's petition is dismissed.

DAVIS, *Judge*, dissenting:

I see this as one of those relatively rare instances in which a claimant has legal entitlement to a promotion. Subchapter 4–3b of Chapter 335 of the Federal Personnel Manual (quoted in footnote 3 of the court's opinion) seems to me to fit all the metes and bounds of this case. In November 1970 management deliberately added to the GS–13 position some additional duties which plaintiff performed for over a year. This new function was "perhaps the most significant factor" in determining whether the Assistant Chief position, GS–13, was worthy of a GS–14 grade level. According to the Joint Stipulation of Fact, "Mr. Skrobot made several unsuccessful efforts to have a desk audit or evaluation conducted of his

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[14] Since plaintiff's "career promotion" argument fails because we cannot substitute our judgment for agency discretion, we find it unnecessary to analyze the steps taken by the Agency in terms of "planned management action."

Assistant Chief, GS–13 position after the post award function was put into his job in November, 1970. Management failed to conduct such an evaluation for the approximately 15 months interim between placing of the post award function in his job in November, 1970, and his reassignment from the Assistant Chief job on July 30, 1972." The Joint Stipulation then goes on to say: "Mr. Skrobot, as Assistant Chief, GS–13, performed substantially the same duties from November, 1970, until his reassignment in July, 1972, as constituted the new Assistant Chief position at Grade GS–14." There is also no doubt that the plaintiff met the legal and qualification requirements for the higher grade; he had been doing the work for considerably more than a year.

On this undisputed factual predicate I would hold that the upgrading of the post from GS–13 to GS–14 was, in the terms of the Federal Personnel Manual, an upgrading "without significant change in duties and responsibilities" on the basis of "the issuance of a new classification standard" (for the new GS–14 position) or of "the correction of a classification error" (in the old GS–13 job). The words fit very well in their ordinary sense, and that normal meaning furthers the obvious purpose of the rule to assure incumbents that they will get the benefit of the upgrading of the same jobs they have already been satisfactorily filling for some time.

To interpret Subchapter 4–3b, as the court does, to refer only to a formal change in the original job description—no matter how much has meanwhile been officially added to the position or how long the incumbent has been performing the added duties—is to limit the provision, without adequate ground, to only one-half of the instances included within the sweep of the words and the apparent objective. I can see no persuasive reason why the Federal Personnel Manual should wish to protect those employees sitting in posts with job descriptions which were incorrect from the beginning—and not those whose duties are officially increased while they are on the job and who then perform the original plus the added functions for over a year. To my mind that would be a technical and haphazard distinction, completely arbitrary in its impact and unrelated to the real world. From the employee's viewpoint there is no warning in the words of the

subchapter that any such peculiar difference is being established.

The court fears that the reading I espouse would lead to administrative chaos and massive litigation. I do not share that prophecy. In this case the employee did not simply undertake additional work but was officially ordered to do it—and this extra work was "perhaps the most significant factor" in the upgrading of the position. He filled the expanded job for over a year and during that period sought several times, unsuccessfully, to have the slot upgraded. Ultimately, the post was reclassified but he was not put into it. This does not seem, in its totality, to be a common situation. If it is, then (in my view) the employees are entitled under the terms and spirit of the Manual to fill the higher grade. The Civil Service Commission can abolish or change the regulation for the future if it feels it misspoke itself in 4–3b or unwittingly opened the door to chaos.

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526 F. 2d 805

TANKER HYGRADE NO. 18, INC. v. THE UNITED STATES; MOTOR TUG CRUSADER, INC.,* ET AL., THIRD-PARTY DEFENDANTS

[No. 439–73. Decided December 17, 1975]**

ON DEFENDANT'S MOTION AND THIRD-PARTY KEHOE'S CROSS-MOTION FOR SUMMARY JUDGMENT

Pollution control; oil spill; recovery of clean-up costs; collateral estoppel.—Plaintiff corporation (a wholly-owned subsidiary of Ira S. Bushey & Sons, Inc. "Bushey"), seeks to recover clean-up costs resulting from an oil spill on a navigable United States waterway pursuant to 33 U.S.C. § 1161(i)(1) of the Federal Water Quality Improvement Act of 1970. Plaintiff's non-self-propelled barge Hygrade No. 18 while being pushed by the tug Joan Kehoe (independently owned) struck a rock formation at the bank of the New York State Barge Canal, as a result of which part of her cargo of No. 6 fuel oil was discharged through the hole caused by the contact. Plaintiff promptly cleaned up the discharged oil. Plaintiff originally alleged that the discharge was caused solely by an act

*Although appearing as a third-party defendant in this case, Motor Tug Crusader, Inc. did not participate with regard to the subject motion.

**On March 16, 1976 plaintiff and Clayton P. Kehoe Towing Co., Inc., et al., third-party defendants, filed petitions for writ of certiorari.

Syllabus

or omission of a third party or third parties, and in its pre-trial submission alternatively contended that the tug Joan Kehoe caused the spill or that the tug Seneca (owned by Motor Tug Crusader, Inc., a subsidiary of Bushey) was the cause of the spill. In *United States* v. *Ira S. Bushey & Sons, Inc.*, 363 F. Supp. 110 (D. Vt. 1973), the cause of the oil spill was litigated and it was found that the barge Hygrade No. 18 was struck by the tank barge Blue Line No. 107 being pushed by the tug Seneca, both owned by corporations which are Bushey subsidiaries; the resulting collision caused Hygrade No. 18 to strike rocks causing the discharge of fuel oil. The court further found that public interest in preserving environmental integrity of the waters in which there had been numerous prior oil spills involving Bushey-controlled vessels, dictated that the parent corporation which profited from the operations of its alter egos should be accountable by piercing the corporate veil of the separate corporate entities since they are mere corporate shells established for purposes of avoiding tort liability to the parent for their acts. It is *held* that finding 28 of *Bushey, supra*, relates to the identical spill involved here. It is also *held*, following examination of the scope of the *Bushey, supra*, findings, that plaintiff is estopped to relitigate the cumulative effect of findings 48, 61, 62 and 63. Defendant's motion for summary judgment is granted and plaintiff's petition including the alternative pre-trial contentions is dismissed. Action respecting the third-party defendants is also set forth, including dismissal of Kehoe's motion for summary judgment.

Judgments; former adjudications; collateral estoppel.

[1] Where the second action between the same parties is upon a different cause or demand, the judgment in the prior action operates as an estoppel, not as to matters which might have been litigated and determined, but only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered. Matters which were actually litigated and determined in the first proceeding cannot later be relitigated.

Judgment ⇐ 713(2), 720

Judgments; former adjudications; res judicata/collateral estoppel; cumulative effect view rule.

[2] In *Halpern* v. *Schwartz*, 426 F. 2d 102 (2d Cir. 1970), the court held in applying the collateral estoppel rule that when a prior judgment rested on independent alternative grounds, the judgment will not foreclose reconsideration of an issue if that issue was not necessary to the rendering of the prior judgment. It is not necessary for this court to rule whether the *Halpern* approach is sound because the rule is not applicable under the facts of this case. The nine Bushey-connected oil spills were not for alternative consideration but were offered and received by the district court for the cumulative effect and the district court found that due to the cumulative

effect of the nine Bushey-connected oil spills the Government was entitled to equitable relief.

Judgment ⇐ 728

Stephen J. Buckley, attorney of record, for plaintiff and for third-party defendant Tanker Hygrade No. 24, Inc. *McHugh, Heckman, Smith & Leonard*, of counsel.

Robert P. Whelan, attorney of record, for third-party defendants Clayton P. Kehoe Towing Company, Inc. and Martin J. Kehoe Towing Company, Inc. *Darby, Healey, Stonebridge & Whelan* and *Francis J. McCaffrey, Jr.*, of counsel.

Rosemary Denson, with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Before DURFEE, *Senior Judge*, NICHOLS and KASHIWA, *Judges*.

KASHIWA, Judge, delivered the opinion of the court:

This is a suit by plaintiff against the United States to recover clean-up costs resulting from an oil spill on one of the navigable waterways of the United States. We deny plaintiff's claim and grant defendant's motion for summary judgment for reasons hereinafter stated.

Jurisdiction of this court over this action is founded upon 33 U.S.C. § 1161(i)(1) (1970), entitled "Control of pollution by oil." [1]

Plaintiff is a corporation organized under the laws of the State of Delaware with offices at Brooklyn, New York. It is a wholly owned subsidiary of Ira S. Bushey & Sons, Inc. (hereinafter Bushey). It was the owner of the tank barge HYGRADE NO. 18, a non self-propelled vessel. On Sep-

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[1] 33 U.S.C. § 1161(i)(1) (1970) reads as follows:

"(i)(1) In any case where an owner or operator of a vessel or an onshore facility or an offshore facility from which oil is discharged in violation of subsection (b)(2) of this section acts to remove such oil in accordance with regulations promulgated pursuant to this section, such owner or operator shall be entitled to recover the reasonable costs incurred in such removal upon establishing, in a suit which may be brought against the United States Government in the United States Court of Claims, that such discharge was caused solely by (A) an act of God, (B) an act of war, (C) negligence on the part of the United States Government, or (D) an act or omission of a third party without regard to whether such act or omission was or was not negligent, or of any combination of the foregoing clauses."

tember 30, 1972, the barge HYGRADE NO. 18, loaded with a cargo of No. 6 fuel oil, was enroute from Rensselaer, New York, to Ticonderoga, New York, pushed by the tug JOAN KEHOE, owned and operated by Clayton P. Kehoe Towing Company, Inc., a company independent and not connected with Bushey in any way. At about 11:45 p.m. on that day the side of the barge HYGRADE NO. 18 came into contact with a rock formation at the bank of the New York State Barge Canal, as a result of which part of her cargo was discharged through a hole caused by that contact. Plaintiff alleges in its petition that, pursuant to the provisions of 33 U.S.C. § 1161 (1970), it promptly undertook to remove the discharged oil from the navigable waters of the United States of America and caused the same to be accomplished at a reasonable cost to plaintiff of $152,500. Plaintiff further alleges generally that the said discharge was caused solely by an act or omission of a third party or third parties. In its pre-trial submission, plaintiff has taken an alternative position that the tug JOAN KEHOE pushing barge HYGRADE NO. 18 caused the spill or that the tug SENECA, owned by Motor Tug Crusader, Inc., a Bushey subsidiary, was the cause of the oil spill. Plaintiff prays in its petition that by reason of the foregoing and pursuant to the provisions of 33 U.S.C. § 1161(i)(1) (1970) plaintiff is entitled to recover from the United States the sum of $152,500.

Plaintiff sued the United States as a sole-party defendant. The United States filed an answer denying liability and filed a timely third-party petition against the following third-party defendants:

1) Motor Tug Crusader, Inc.
2) Clayton P. Kehoe Towing Company, Inc.
3) Martin J. Kehoe Towing Company, Inc.
4) Tanker Hygrade No. 24, Inc.

The United States claims in the third-party petition:

> That if any judgment be entered against the United States of America in favor of plaintiff Tanker Hygrade No. 18, Inc., herein, that a judgment be awarded in favor of the United States of America and against third-party defendant Motor Tug Crusader, Inc., third-party defendant Clayton P. Kehoe Towing Company, Inc.,

third-party defendant Martin J. Kehoe Towing Company, Inc., and third-party defendant Tanker Hygrade No. 24, Inc., requiring each of said third-party defendants, jointly and severally, to pay to the United States of America the amount of any such judgment and to indemnify and exonerate the United States of America against any and all liability herein; * * *. [At pp. 4–5.]

All of said third-party defendants were duly served and each of them answered the third-party petition of the United States, denying any liability. In addition to answers, the two Kehoe companies have filed a joint motion for summary judgment. We shall refer to this joint motion at the end of this opinion.

The United States in the meantime filed a motion for summary judgment against plaintiff, Tanker Hygrade No. 18, Inc. We quote from a memorandum attached to said motion (at pp. 2–4), stating the grounds for said motion:

> Plaintiff, Tanker Hygrade No. 18, Inc. (hereinafter Hygrade 18) has filed its action under 33 U.S.C. 1161(i) of the Federal Water Quality Improvement Act of 1970 (Pet. Paragraph 1).
>
> Title 33 U.S.C. 1161(i) provides in part:
>
> "In any case where an owner or operator of a vessel * * * from which oil is discharged in violation of subsection (b)(2) of this section acts to remove such oil * * * such owner or operator shall be entitled to recover the reasonable costs incurred in such removal upon establishing * * * that such discharge was caused *solely by an act or omission of a third party* * * *." (emphasis added)
>
> In its pretrial submission Hygrade 18 contends that the tug JOAN KEHOE was the cause of the oil spill (Pretrial Submission 1(c)(1)). Title 33 U.S.C. 1161(i) requires that plaintiff prove that the discharge was *caused solely* by an act or omission of a *third party*.
>
> The cause of the September 30, 1972 incident has already been decided in *United States* v. *Ira S. Bushey & Sons, Inc.*, 363 F. Supp. 110, 115 (D. Vt. 1973), aff'd 487 F. 2d 1393 (2d Cir. 1973), cert. denied 417 U.S. 976 (1974), and the findings in that case clearly preclude any recovery by plaintiff under 33 U.S.C. 1161(i).
>
> *Bushey* found that the barge BLUE LINE 107, push towed by the tug SENECA, caused the oil spill from HYGRADE 18 on September 30, 1972, in the Lake

Champlain Canal. *Bushey*, pp. 115–116. However, HYGRADE 18 now comes to the Court of Claims attempting to relitigate these findings and asserts that the spill was caused solely by the JOAN KEHOE. Query why HYGRADE 18 does not assert that the SENECA or BLUE LINE 107 caused the spill and support its claim with the findings in *Bushey*, p. 115–116, 119.

The answer is glaringly revealed in *Bushey* where the court found that the public interest to preserve the environmental integrity of Lake Champlain—threatened by numerous Bushey oil spills—dictated that the corporate veil of Bushey should be pierced. Bushey, p. 119. The court found that the corporations owning HYGRADE 18, the SENECA and BLUE LINE 107 are wholly-owned subsidiaries of the same parent company, Ira S. Bushey & Sons, Inc., and that those three vessel-owning corporations were "mere corporate shells established for purposes of avoiding tort liability to the parent for the acts of the subsidiaries which are the alter egos of Bushey." *Bushey* p. 119.

Under 33 U.S.C. 1161(i), HYGRADE 18 would have to prove that the spill was caused solely by an act or omission of a third party in order to be reimbursed for the money spent for cleaning up the oil spill. Since the SENECA and BLUE LINE 107 are not third parties in relation to HYGRADE 18 because of their "alter ego" relationship to Bushey, this action must fail.

On collateral estoppel we quote from *Sea-Land Services, Inc.* v. *Gaudet*, 414 U.S. 573, 593 (1974), a recent case:

> Collateral estoppel applies "where the second action between the same parties is upon a different cause or demand * * *. In this situation, the judgment in the prior action operates as an estoppel, not as to matters which might have been litigated and determined, but 'only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered.' *Cromwell* v. *County of Sac*, [94 U.S. 351,] 353. And see *Russell* v. *Place*, 94 U.S. 606; *Southern Pacific R. Co.* v. *United States*, 168 U.S. 1, 48; *Mercoid Corp.* v. *Mid-Continent Co.*, 320 U.S. 661, 671. Since the cause of action involved in the second proceeding is not swallowed by the judgment in the prior suit, the parties are free to litigate points which were not at issue in the first proceeding, even though such points might have been tendered and decided at that time. *But matters which were actually litigated and determined in the first proceeding cannot later be relitigated.*" *Com-*

missioner v. *Sunnen*, 333 U.S., at 597–598. [Emphasis supplied.]

We shall first quote the district court's finding number 28 from *United States* v. *Ira S. Bushey & Sons, Inc.*, 363 F. Supp. 110, 115–116 (D. Vt. 1973), affirmed in toto without opinion in 487 F. 2d 1393 (2d Cir. 1973), *cert. denied*, 417 U.S. 976 (1974):

> 28. On September 30, 1972, while under way between Locks 9 and 11 of Lake Champlain Canal, barge Hygrade No. 18, owned by the Tanker Hygrade No. 18, Inc., a wholly-owned Bushey subsidiary, was struck by the tank barge Blue Line No. 107 being pushed by the tug Seneca, both owned by corporations which are wholly-owned by Bushey subsidiaries. The resulting collision caused the Hygrade No. 18 to strike rocks on the bottom of the canal which caused No. 6 fuel oil to leak from Hygrade No. 18 into the canal. The canal flows north into Vermont waters of Lake Champlain, but there is no evidence that the oil spilled in the canal did so flow. But Hygrade No. 18 proceeded into Lake Champlain and toward Ticonderoga after the ramming and oil was seen to bubble out of it into the lake.
>
> (A) Before the collision, the captain of the tug Kehoe, which was pushing tank barge Hygrade No. 18, was in radio communication with the captain of the tug Seneca, which was pushing the tank barge Blue Line No. 107. The captain of the tug Seneca agreed to hold back at Bray Terminal, which was an area wide enough for the vessels to pass. After agreeing to do this, the captain of the tug Seneca disregarded the agreement, and proceeded about three-quarters of a mile southerly. As the tug and barge approached each other, the captain of the Kehoe brought his tug and barge to a halt and he attempted by radio to warn the Seneca and Blue Line No. 107 not to pass. The captain of the Seneca did not answer the radio warning, and the barge Blue Line No. 107 hit the Hygrade No. 18 while attempting to pass, resulting in the damage to the Hygrade No. 18 and a subsequent oil spill.
>
> (B) The Hygrade No. 18 spilled between 200 and 1,145 gallons of No. 6 oil along some six miles of the canal and also in the Vermont waters of Lake Champlain.
>
> (C) The spill from Hygrade No. 18 was such as to cause defendant Bushey to expend the sum of $150,000 in cleaning the Champlain Canal of No. 6 oil.

There is no question that the oil spill referred to in finding number 28 is the identical spill the clean-up expenses of which

are the subject matter of this action in this court. Hereafter, we shall refer to this finding as finding 28.

We further quote the following finding of the district court at page 119 of its opinion:

> As previously held, this court has jurisdiction of the parties and venue in the District of Vermont is proper. *Public policy dictates that the veil of Bushey's and Spentonbush's separate corporate entities be pierced, since these corporations wholly own, control, manage, operate and in all ways supervise the operations of the many subsidiaries of Bushey. See* United States v. Ira S. Bushey & Sons, Inc., No. 6380 (D. Vt., Oct. 11, 1972) (unpublished opinion on motions to sever and transfer). *The subsidiaries are mere corporate shells established for purposes of avoiding tort liability to the parent for the acts of the subsidiaries which are the alter egos of Bushey and Spentonbush. Cf.* United States v. Parfait Powder Puff Co., 163 F. 2d 1008, 1010 (7th Cir. 1947), cert. denied, 332 U.S. 851, 68 S. Ct. 356, 92 L. Ed. 421 (1948). Injunctive relief against only one or a few of the subsidiaries could easily be circumvented by the parent, with the assistance of the similarly wholly owned Spentonbush, simply by using other subsidiary corporations to make petroleum deliveries to Vermont. The public interest in preserving the environmental integrity of Lake Champlain, the sixth largest lake in the country and a jewel of nature, is sufficiently paramount that the parent corporation, Bushey, which profits from the operations of its alter-ego subsidiaries, should be accountable for any violation or continuing threat of violations to that integrity. [Emphasis supplied.]

This finding is not numbered in that it is in the opinion portion of the decision. We shall hereafter refer to the foregoing finding as the piercing-corporate-veil finding. The district court based it on additional findings numbered 1 to 9.[2]

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[2] The district court's findings numbered 1 to 9 are as follows:

"1. Defendant Ira S. Bushey & Sons, Inc. (hereinafter "Bushey"), is a New York corporation having offices at 764 Court Street, Brooklyn, New York.

"2. Spentonbush Transport Service, Inc. (hereinafter "Spentonbush"), is a wholly-owned subsidiary of Bushey and a New York corporation having offices at 500 Fifth Avenue, New York, New York.

"3. The directors of Bushey and the directors of Spentonbush are the same persons, Francis B. Bushey, Ira S. Bushey and Raymond J. Bushey. The officers of Bushey and Spentonbush are substantially the same.

"4. Defendant Bushey wholly owns approximately 40 corporations, each of which owns vessels used in the transportation of liquid cargoes; of these

(Continued)

Defendant's position is that since under § 1161(i)(1) plaintiff cannot recover unless it proves that the discharge was caused *solely by an act or omission of a third party*, this case should be summarily decided in defendant's favor because collateral estoppel prevents plaintiff from relitigating both finding 28 and the piercing-corporate-veil finding.

Plaintiff in response to defendant's motion for summary judgment argues that finding 28 was not necessary and essential to the resulting judgment of the district court which granted injunctive relief. It states that findings of the district court, taken as a whole, led to the district court's decision to issue an injunction but a finding with respect to each incident by itself was not necessary and essential to the district court's decision to grant injunctive relief. Plaintiff cites and relies on *Halpern* v. *Schwartz*, 426 F. 2d 102 (2d Cir. 1970), wherein the court in a petition for discharge in bankruptcy, proceeding with relation to a prior judgment adjudicating petitioner bankrupt, stated:

> This case presents a unique issue in the law of collateral estoppel which has not been analyzed exhaustively by any court. When the prior judgment rested on several (here three) independent, *alternative grounds*, is that judgment conclusive as to the facts which were necessarily found in order to establish only one separate

Continued)
approximately 25 tugs and barges are capable of operating in the Vermont waters of Lake Champlain, a navigable water of the United States, and most of these vessels do in fact operate in Vermont waters. Among such vessels are Tanker Hygrade No. 8, owned by defendant Tanker Hygrade No. 8, Inc., and the tug Carmelite owned by defendant Tug Carmelite Corporation.

"5. Spentonbush is and has been for a number of years engaged in the business of the solicitation of orders for transportation of liquid cargoes by water, and of arranging for performance of such transportation by vessels, and it gives preference to vessels of Bushey subsidiaries in arranging water transportation contracts.

"6. Spentonbush collects transportation charges for such water transportation, deducts a commission and remits the balance to the owners of the particular tank barge and tug boat involved.

"7. Since December, 1970, crews used by vessels owned by Bushey subsidiaries have been hired and employed either by Spentonbush or by Hygrade Operators, Inc., a wholly-owned subsidiary of Bushey.

"8. None of the wholly-owned, vessel-owning, corporate subsidiaries of Bushey operating in Lake Champlain employs its own crew, its own accounting personnel, or any other employees except for its officers. The officers and directors of each subsidiary corporation, except Spentonbush, are identical to the officers and directors of defendant Bushey.

"9. The net profit or surplus from the operations of Spentonbush and other wholly-owned Bushey subsidiaries are remitted to Bushey by way of corporate dividends." [At pp. 111–112.]

ground? We conclude that on the facts before us it is not.

It is well established that although an issue was fully litigated and a finding on the issue was made in the prior litigation, the prior judgment will not foreclose reconsideration of the same issue *if that issue was not necessary to the rendering of the prior judgment, and hence was incidental, collateral, or immaterial to that judgment.* Norton v. Larney, 266 U.S. 511, 517, 45 S. Ct. 145, 69 L. Ed. 413 (1925); Fibreboard Paper Products Corp. v. East Bay Union of Machinists, Local 1304, 344 F. 2d 300, 306 (9 Cir. 1965); United States v. Rodiek, 117 F. 2d 588, 593 (2d Cir. 1941), aff'd, 315 U.S. 783, 62 S. Ct. 793, 86 L. Ed. 1190 (1942); Restatement of the Law of Judgments § 68, Comment o (1942); 1B Moore, Federal Practice ¶ 0.443[5] at 3919 (1965). The reason for this rule is twofold. First, the decision on an issue not essential to the prior judgment may not have been afforded the careful deliberation and analysis normally applied to essential issues, since a different disposition of the inessential issue would not affect the judgment. Irving Nat'l Bank v. Law, 10 F. 2d 721, 724 (2d Cir. 1926) (L. Hand, J.). * * * [At pp. 104–105, emphasis supplied.]

* * * * *

We therefore hold that when a prior judgment adjudicating one a bankrupt rests on two or *more independent alternative grounds*, it is not conclusive as to issues in trial of objections to discharge which issues were necessarily found in order to establish only one of those grounds. In so holding, we think distinguishable the only other case we have found in this circuit which ruled on a somewhat similar issue, Kessler v. Armstrong Cork Co., 158 F. 744 (2d Cir. 1907), cert. denied sub nom. Sexton v. Armstrong Cork Co., 207 U.S. 597, 28 S. Ct. 262, 52 L. Ed. 357 (1908). To the extent that Patterson v. Saunders, 194 Va. 607, 74 S.E. 2d 204 (1953), Sheldon v. Edwards, 35 N.Y. (8 Tiffany) 279 (1866), Annot., 133 A.L.R. 840, 846 (1941) are to the contrary, we decline to follow them. [At pp. 106–107, footnotes omitted, emphasis supplied.]

In *Stebbins* v. *Keystone Insurance Co.*, 481 F. 2d 501, 507–508 (D.C. Cir. 1973), the court of appeals, with relation to *Halpern* v. *Schwartz*, *supra*, after stating that it was the only case in the past 20 years to consider the question, stated as follows:

> Collateral estoppel has shown itself to be an extremely useful device for reducing the crush of litigation in the trial courts, and it goes a long way toward eliminating inconsistent decisions in cases with identical fact patterns and a common party. In part for these reasons, the recent trend has been to broaden the scope of its application. *Halpern*, of course, runs against this current. The *Halpern* rule was evolved in the context of a bankruptcy case. We need not decide whether the *Halpern* approach is sound if applied as a general rule to a wide range of matters. * * * [Footnote omitted.]

But the court of appeals permitted the *Halpern* rule to apply only to very narrow facts of the case with relation to a matter which was curable anyway.

As in *Stebbins* v. *Keystone Insurance Co.*, *supra*, we need not decide whether the *Halpern* approach is sound because the rule in *Halpern* is not applicable under the facts of this case. *Halpern* limits its application to a prior judgment resting on two or more independent, *alternative* grounds. In *Halpern* the three grounds were clearly in the alternative but in the present case the nine Bushey-connected oil spills between August, 1967, and November, 1972, were not for alternative consideration, instead they were offered and received by the district court for the cumulative effect. The district court found that the cumulative effect justified the issuance of the injunction. Findings 48, 61, 62, and 63 of the district court clearly support our cumulative-effect view:

> 48. During the past five years, the nine oil spills in Vermont waters of Lake Champlain, involving Bushey controlled vessels, have either damaged, or presented a substantial risk of damage, to Vermont beaches, a major municipal water supply, and to waterfowl and fish, particularly in the Burlington-Shelburne harbor areas.
>
> * * * * *
>
> 61. Due to the numerous oil spills involving defendants Bushey and Spentonbush, and due to the violations of the Refuse Act by Bushey and Spentonbush, as appears from the records in the United States District Court for the District of Vermont, the court finds that the Government is entitled to equitable relief against defendants Bushey and Spentonbush.
>
> 62. The court finds that the numerous oil spills that have occurred together with the continuation of slack

operations by defendants as above described poses a continuing nuisance threatening the general public, wildlife, lakefront property owners and the environment of Lake Champlain and its shore lines.

63. The court finds that the numerous past oil spills that have occurred, the continuation of slack operations by defendants and the damaging effects of oil spills cause a continuing threat of irreparable harm to the navigable waters of the United States and hence to the plaintiff. [*Bushey*, *supra*, at 117, 119.]

With relation to the oil spill involved in this case, described in finding 28, the oil which spilled was No. 6 fuel oil. The court in finding 19 described the difference in effect on water between more volatile oils such as jet fuel as compared to heavy heating oil as follows:

> 19. The effect of an oil spill on water varies with the kind of spill—jet fuel evaporates quickly while heavy heating oil does not—and environmental conditions; with certain kinds of oil under certain conditions, as those of turbulence, shear forces at the oil-water interface may prevail causing an influx of oil into the water column rather than mere confinement of it to the surface where it may be more easily contained. [*Bushey*, *supra*, at p. 113.]

Of the nine oil spills listed, six were of the quickly evaporating type, such as gasoline, kerosene, or jet fuel; the remaining three spills covered by findings 25, 26, and 28 were of the heavy heating oil type. Of all nine spills it appears from the findings in finding 25 that the spill of the heavy heating oil in finding 25 was the most damaging. The oil spill in finding 28, the spill in issue herein, was of the heavy oil type, as in finding 25, causing with the other spills and the slack operations by the Bushey organizations a continuing threat of irreparable harm to the navigable waters of the United States. Plaintiff is estopped to relitigate the cumulative effect of findings in findings 48, 61, 62, and 63.

The inexcusable operation of the tug SENECA, whereby two of the Bushey barges collided as found in finding 28, was the very type of "slack operation" the district court was referring to in findings 62 and 63 above quoted. In finding 27 the slack operation involved the officer in charge being under the influence of alcohol. These slack operations in

findings 27 and 28 cumulatively with the other seven described operations caused a continuing threat of irreparable harm to the navigable waters involved. Plaintiff is estopped from relitigating the cumulative effect found by these slack operations in findings 48, 61, 62, and 63.

With relation to cumulative findings in *Hawes* v. *Contra Costa Water Co.*, 11 F. Cas. 862 (No. 6,235) (C.C. S.D. Cal. 1878), *aff'd*, 104 U.S. 450 (1882), which involved the effect of a decree of a State court as an authoritative construction of a state statute, binding upon a Federal court, the court stated:

> * * * Both grounds were distinctly and squarely presented by the record, and relied on, and the latter more especially fully argued by counsel. The court might just as well have rested its decision on the second ground, if found good, without noticing the first, as upon the first without noticing the second. Or it might, if thought proper, have decided both, as it did. It is a matter of almost everyday occurrence that the record presents two or more points, either of which, if sustained, would determine the case, and the court decides them all. In such case it can no more be said that one rather than the other is obiter. * * * [At p. 865.]

See, also, *First Nat'l Bank* v. *Covington*, 129 F. 792 (C.C. E.D. Ky. 1903), *aff'd* 198 U.S. 100 (1905), wherein the court stated:

> * * * The fact that the judgment of a court in a suit might have been based upon another ground than that on which it was actually based does not prevent the determination that such ground existed being conclusive as to its existence in a subsequent suit between the same parties, if its existence was in issue in the former suit, and properly formed the basis of the judgment therein. * * * [At p. 796.]

The cumulative effect view rule is well put in Freeman, Judgments § 698 (5th ed.), wherein it is stated:

> * * * there is a difference between a finding or adjudication which is immaterial and one which is material, though perhaps unnecessary in view of other findings. The mere fact that the court goes further than is absolutely necessary to sustain its judgment in determining material issues presented to it does not prevent such issues from becoming res judicata.

Syllabus

We hold as follows:

1) Defendant's motion for summary judgment is granted and plaintiff's petition (hereafter petition-in-chief), including plaintiff's alternative positions in its pre-trial submissions, is dismissed;

2) The contingent claims of the United States against the two third-party defendants Motor Tug Crusader, Inc. and Tanker Hygrade No. 24, Inc. are also dismissed because of the dismissal of the petition-in-chief in (1) above;

3) With relation to the joint cross motion for summary judgment by the two third-party defendants Clayton P. Kehoe Towing Company, Inc. and Martin J. Kehoe Towing Company, Inc.:

a. that portion requesting summary judgment dismissing the petition-in-chief is allowed by reason of the dismissal of the petition-in-chief in (1) above and

b. that portion requesting dismissal of the impleading petition is allowed by reason of the dismissal of the petition-in-chief in (1) above.

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527 F. 2d 613

CONTINENTAL MANAGEMENT, INC. AND STATE-SIDE INVESTMENT CORP.; FEDERAL DEPOSIT INSURANCE CORP., THIRD-PARTY PLAINTIFF v. THE UNITED STATES

[No. 223-74. Decided December 17, 1975]

ON PLAINTIFFS' MOTION TO DISMISS DEFENDANT'S FIRST COUNTERCLAIM AND DEFENDANT'S CROSS-MOTION FOR PARTIAL SUMMARY JUDGMENT

Bribery of public officials; liability of briber to Government for amount of bribes.—Continental Management, Inc. (formerly Inter-Island Mortgagee Corp. "Inter-Island") and its wholly-owned subsidiary State-Side Investment Corp., until 1972 were FHA-approved mortgagees engaged in originating mortgages for insurance by FHA or for guaranty by the Veterans Administration. Plaintiffs seek to recover sums allegedly due them under certain contracts of mortgage insurance issued by FHA. In 1972 the companies were suspended as approved mortgagees resulting from FBI investigative evidence that various officers and employees of the companies (particularly Stanley Sirote, the then-president and a member of

Syllabus

the board of directors of Inter-Island) had violated federal statutes prohibiting bribery, conspiracy and the making of false statements to the Department of Housing and Urban Development. Subsequently, Sirote and four FHA employees pleaded guilty to bribery. Defendant, in its first counterclaim, seeks to collect from plaintiffs an amount equal to the sum of the bribes paid by Sirote to the federal employees. Plaintiffs have moved to dismiss the counterclaim as failing to state a claim, and defendant has moved for partial summary judgment claiming that the companies are liable on the counterclaim. It is *held* that the bribery for which plaintiffs are responsible was a wrong against the defendant for which plaintiffs are liable in damages in the amount of the bribes paid. The first counterclaim is valid and plaintiffs' motion to dismiss it is denied. Defendant's motion for partial summary judgment is granted to the extent that plaintiffs are held liable for the bribes, gratuities and secret emoluments paid by or on behalf of plaintiffs to federal employees. The amount of defendant's recovery will be determined under Rule 131(c).

Agency; liability of corporation for acts of officers; criminal acts.

[1] A corporation is responsible for the acts of its incumbent president in paying bribes to Government employees in violation of 18 U.S.C. § 201(f) and the rigid standard of conduct established by that statute.

Corporations ⇐ 526

Pleading and practice; counterclaims; Government right of.

[2] Under this court's counterclaim statute and Rules, the Government may set up a counterclaim even though it does not arise out of the transaction or occurrence that is the subject matter of the petition and the counterclaim states a claim of a type (e.g. tort) of which this court would not have jurisdiction if sought to be maintained by a plaintiff.

Courts ⇐ 450

Agency; breach of duty by agent; inducement by third party.

[3] A third party's inducement of or knowing participation in a breach of duty by an agent is a wrong against the principal which may subject the third party to liability.

Torts ⇐ 12

Agency; breach of duty by agent; bribery of agent.

[4] An agent's receipt of secret profits injures the principal because it necessarily creates a conflict of interest and tends to subvert the agent's loyalty. Judicial pronouncements evidence the strong policy against payment of money or other benefits to another's agent, a commitment to giving full relief to the principal, a willingness to draw all reasonable inferences from the available evidence, and a flexibility in devising remedies to run against all available participants.

Torts ⇐ 12

Syllabus

Bribery, graft and conflicts of interest; bribery of public officials; damages.

[5] The purpose of the bribery statute, 18 U.S.C. § 201—the protection of the public from corruption of public servants and the evil consequences of that corruption—will be furthered by recognition of a civil remedy, such as the Government's monetary redress against the briber predicated on the probability that damages flow from the giving of the bribe. The briber deprives the Government of the loyalty of its employees upon whom it and the public must rely for impartial and rigorous enforcement of Government programs, public confidence upon which the Government must also rely is impaired, and administrative and investigative costs are incurred by reason of the corrupt influencing of the employees.

United States ⇐ 126

Bribery, graft and conflicts of interest; bribery of public officials; damages; proof of damages.

[6] Where the fact of injury is adequately shown, the court should not cavil at the absence of specific or detailed proof of the damages. Thus, where plaintiffs clearly hurt the Government by bribing and corrupting its public servants, it is enough to show the fact and amount of the bribes, and nothing further need be alleged or proved by way of specific or direct injury. As between the briber and the Government as employer of the bribees, the risk of damage determination falls on the former.

United States ⇐ 141(3)

Bribery, graft and conflicts of interest; bribery of public officials; damages; measure of damages.

[7] On the premise that damages flow from the giving of a bribe to a Government servant and that the briber must bear the risk of damage determination, the amount of the bribe (the value which the briber placed on the corruption of the employee) provides a reasonable measure of damages, in the absence of a more precise yardstick.

United States ⇐ 142

Agency; breach of duty by agent; participants in corruption; damages recoverable.

[8] All knowing participants in a scheme involving an agent's breach of duty may be held jointly liable to the principal for the agent's secret profits. However, the Government cannot recover the amount of the bribes twice, once from the briber and again from the corrupted employees.

United States ⇐ 142

Bribery, graft and conflicts of interest; bribery of public officials; penal/remedial causes of action.

[9] The fact that the Government has pursued a penal remedy against the briber of public officials and secured a conviction under 18 U.S.C. § 201(f), does not preclude its recovery of the amount of

the bribes from the briber in a civil action since such action is remedial in nature and is designed to compensate the Government for the harm it has suffered. One act of wrongdoing may give rise to both civil and criminal liability.

United States ⇐ 126

Bribery, graft and conflicts of interest; bribery of public officials; penal/remedial causes of action; common law rights and remedies.

[10] The existence of extensive legislation governing bribery and fraud penalties does not rule out the Government's maintenance of a civil action based on a common law right; it establishes a statutory standard of conduct and evidences a strong policy against corruption of public officials. A statutory remedy is not exclusive, and common law rights and remedies survive, unless Congress intended the legislative provision to be exclusive.

United States ⇐ 126

J. Michael Hines for plaintiff; *James A. Treanor, III*, attorney of record. *Daniel M. Redmond* and *Dow, Lohnes & Albertson*, of counsel.

Werner Goldman for Federal Deposit Insurance Corp., third-party plaintiff. *Douglas H. Jones*, of counsel.*

Alexander Younger, with whom was *Assistant Attorney General Rex E. Lee*, for defendant. *Leslie H. Wiesenfelder*, of counsel.

Before DAVIS, NICHOLS, and KUNZIG, *Judges*.

DAVIS, *Judge*, delivered the opinion of the court:

Continental Management and State-Side Investment have sued the United States for sums allegedly due them under contracts of mortgage insurance issued by the Federal Housing Administration (FHA). The Government has responded with an answer, a special plea in fraud, and four counterclaims. Only the first counterclaim, in which the Government seeks to collect from plaintiffs an amount equal to the sum of bribes paid by a former president of the plaintiffs' predecessor corporation to employees of the FHA and the Veterans Administration (VA), is before the court at this time on the parties' cross-motions.

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*The third-party plaintiff did not participate in the presentation or argument of the motions disposed of in this opinion.

Continental Management, formerly Inter-Island Mortgagee Corp. (Inter-Island), and State-Side Investment, a wholly owned subsidiary of Continental Management and the successor of the former Inter-Island of Puerto Rico, are mortgage bankers. Until 1972 they (their predecessors) were FHA-approved mortgagees, engaged in originating mortgages for insurance by the FHA or for guaranty by the VA. The companies were suspended as approved mortgagees in that year because an extensive FBI investigation uncovered evidence that officers and employees of Inter-Island had violated federal statutes prohibiting bribery, conspiracy, and the making of false statements to the Department of Housing and Urban Development. The FBI in its investigation focused, as does the Government in its first counterclaim, on the activities of Stanley Sirote, then president and a member of the board of directors of Inter-Island and then and now the principal stockholder of Inter-Island/Continental Management. In an affidavit executed before the suspensions, Sirote detailed payments of money and gifts made by him to numerous FHA and VA employees responsible for appraising property and approving or disapproving applications for mortgage insurance or guaranty submitted by Inter-Island. Subsequently, Sirote pleaded guilty to four bribery charges, and four FHA employees also pleaded guilty to bribery.[1]

The counterclaim challenged here asks for recovery from plaintiffs of the bribes paid by Sirote to the federal employees. The claimants move to dismiss this cross-demand as failing to state a claim; the defendant has reacted by seeking summary judgment that the companies are liable on this counterclaim. As will appear, we hold that the counterclaim embodies a proper demand and that the existing record is sufficient to sustain summary judgment for the Government.

The basic underlying facts are indisputable. The payment of the bribes is attested by Sirote's criminal convictions, the convictions of the bribed federal employees, and by Sirote's own affidavit. Clearly, he was a conscious wrongdoer. His

[1] The Government attached Sirote's affidavit and the indictments and informations against Sirote and the four FHA employees as supporting documentation for its motion for partial summary judgment.

conduct violated not only moral precepts but also the federal criminal statute prohibiting bribery of officials, 18 U.S.C. § 201(f), and the rigid standard of conduct established by that statute. *Cf. United States* v. *Mississippi Valley Generating Co.*, 364 U.S. 520, 549–51, 559 (1961). There is also no doubt that Inter-Island and its successors are responsible for his acts, committed while he was president of Inter-Island. *See Wagner Iron Works* v. *United States*, 146 Ct. Cl. 334, 337–38, 174 F. Supp. 956, 958 (1959), and cases cited. On the other hand, there is no proof or suggestion that the bribes were related, in any specific way, to the particular mortgage transactions on which plaintiffs sue.

Thus, the issue raised by the parties' cross-motions is whether Sirote's actions give rise to liability by the briber to the Government for an amount equal to the bribes, where the Government has shown only that such unlawful payments were made and has not proved direct or specific monetary injury. Contending that the Government must prove the damage resulting from the illegal acts, the plaintiffs assert, as their major point, that the Government's failure to allege provable, measurable damages and a nexus between Sirote's conduct and specific monetary harm to the Government calls for dismissal of the counterclaim, or at best a remand for trial. The defendant replies that the interference with the principal-agent relationship between it and its employees is damage enough, as well as a compensable wrong, that it need prove no other injury, and that on this type of record the amount of the bribes is a sufficient measure of damage.[2]

Though we know of no American case which directly confronts this precise point, an impressive accumulation of decisions pushes hard toward acceptance of the Government's position. It is well-established, as plaintiffs seem to concede, that a third party's inducement of or knowing participation

[2] Under this court's counterclaim statute (28 U.S.C. § 1503) and our rules (Rule 40) the Government may set up a counterclaim even though (a) it does not arise out of the transaction or occurrence that is the subject matter of the petition and (b) it states a claim of a type (*e.g.* tort) of which we would not have jurisdiction if sought to be maintained by a plaintiff. *See Cherry Cotton Mills, Inc.* v. *United States*, 327 U.S. 536 (1946); *Frantz Equip. Co.* v. *United States*, 122 Ct. Cl. 622, 628–31, 105 F. Supp. 490, 494–96 (1952).

in a breach of duty by an agent is a wrong against the principal which may subject the third party to liability. *See, e.g., Martin Co.* v. *Commercial Chemists, Inc.*, 213 So. 2d 477, 480 (Fla. Dist. Ct. App. 1968), *cert. denied*, 225 So. 2d 523 (Fla. 1969); *Hirsch* v. *Schwartz*, 209 A. 2d 635, 640 (N.J. Super., App. Div. 1965); *Singer Sewing Machine Co.* v. *Lang*, 203 N.W. 399, 401 (Wis. 1925); RESTATEMENT (SECOND) OF AGENCY § 312 (1958). In nearly unbroken succession, courts have declared that victimized principals may obtain non-statutory remedies against outsiders who have knowingly participated in or induced an agent's breach of duty. *See City of Boston* v. *Simmons*, 23 N.E. 210, 212 (Mass. 1890) (agent and third party jointly liable where they participated in scheme under which third party bought land that agent knew city might buy, sold it to city at a profit, and divided the profit with agent); *City of Findlay* v. *Pertz*, 66 F. 427, 434–35, 440 (6th Cir. 1895) (contract between city and third party may be voided, unless city has ratified, where third party has paid commissions to city's purchasing agent); *Singer Sewing Machine Co.* v. *Lang*, *supra* (third party liable to principal for damages where inference was strong that third party encouraged or induced agents' breach of duty); *Central Illinois Public Service Co.* v. *Schell*, 238 Ill. App. 560, 565 (1925) (third party was trustee *ex maleficio* of moneys received from principal and paid to agent as kickbacks); *Donemar, Inc.* v. *Molloy*, 169 N.E. 610, 611 (N.Y. 1930) (seller and purchaser's agent liable for amount of bribe former paid to latter); *Kinzbach Tool Co.* v. *Corbett-Wallace Corp.*, 160 S.W. 2d 509, 514 (Tex. 1942) (third party and agent are joint tortfeasors where third party participates in agent's breach of duty; seller and buyer's agent liable for commission paid by seller to buyer's agent); *Anderson* v. *Thacher*, 172 P. 2d 533, 545 (Cal. Dist. Ct. App. 1946) (judgment may be entered against those who participated in agent's breach of duty after a sum is found to be due from the agent); *Hunter* v. *Shell Oil Co.*, 198 F. 2d 485, 488–89 (5th Cir. 1952) (agent and third parties were constructive trustees of mineral interests acquired on basis of confidential information disclosed by agent); *B. F. Goodrich Co.* v. *Naples*, 121 F. Supp. 345, 348

(S.D. Cal. 1954) (all who participate in agent's acquisition of secret profits in breach of his duty are liable with the agent for the secret profits, regardless of whether they benefit from the agent's breach); *United States* v. *Davio*, 136 F. Supp. 423, 428 (E.D. Mich. 1955) (at common law, third parties are liable to principal for kickbacks paid to agents, regardless of proved damage to the principal); *Sears, Roebuck & Co.* v. *American Plumbing & Supply Co.*, 19 F.R.D. 334, 342–45 (E.D. Wis. 1956) (third party liable to principal for commissions paid to principal's purchasing agent); *Hirsch* v. *Schwartz*, *supra* (third party who causes or assists agent's breach of duty may be liable to principal); *Martin Co.* v. *Commercial Chemists, Inc.*, *supra* (third party would have been jointly liable with the agent for agent's secret profits if participation in agent's breach of duty had been knowing). *But see Kuntz* v. *Tonnele*, 84 A. 624, 626 (N.J. Ch. 1912) (third party not liable for one portion of agent's secret profit though he knowingly paid commission to agent).

These cases, perhaps technically distinguishable from that at bar by the fact that the monetary consequences of the agents' nefarious dealings with the third parties could be said to be clearer or more specific, enunciated or reflected the broad principle that an agent's receipt of secret profits injures the principal because it necessarily creates a conflict of interest and tends to subvert the agent's loyalty. Their reasoning suggests that all who knowingly participate in a scheme by which an agent obtains secret profits should be held liable to the principal. *See City of Findlay* v. *Pertz*, 66 F. 427, 434–35 (6th Cir. 1895), *quoted in United States* v. *Carter*, 217 U.S. 286, 307–08 (1910); *B. F. Goodrich Co.* v. *Naples*, 121 F. Supp. 345, 348 (S.D. Cal. 1954); *Sears, Roebuck & Co.* v. *American Plumbing & Supply Co.*, 19 F.R.D. 334, 342–44 (E.D. Wis. 1956); *Anderson* v. *Thacher*, 172 P. 2d 533, 545 (Cal. Dist. Ct. App. 1946); *City of Boston* v. *Simmons*, 23 N.E. 210, 212 (Mass. 1890); *Kinzbach Tool Co.* v. *Corbett-Wallace Corp.*, 160 S.W. 2d 509, 514 (Tex. 1942); *Martin Co.* v. *Commercial Chemists, Inc.*, 213 So. 2d 477, 480 (Fla. Dist. Ct. App. 1968), *cert. denied*, 225 So. 2d 523 (1969). The opinions evidence the strong policy against the

payment of money or other benefits to another's agent,[3] a commitment to giving full relief to the principal, a willingness to draw all reasonable inferences from the available evidence, and a flexibility in devising remedies to run against all available participants. *See especially City of Findlay* v. *Pertz*, *supra* at 435; *Sears, Roebuck & Co.* v. *American Plumbing & Supply Co.*, *supra* at 342–45; *Singer Sewing Machine Co.* v. *Lang*, 203 N.W. 399, 401 (Wis. 1925); *Hunter* v. *Shell Oil Co.*, 198 F. 2d 485, 489, 490 (5th Cir. 1952). *See also* D. DOBBS, REMEDIES 684 (1973).

A sister line of decisions indicates that the violation of a statutory standard of conduct should normally meet with civil sanctions designed to effectuate the purpose of the statute infringed. *See United States* v. *Acme Process Equip. Co.*, 385 U.S. 138, 145 (1966); *United States* v. *Mississippi Valley Generating Co.*, 364 U.S. 520, 548–51, 563 (1961); *Brown* v. *United States*, 207 Ct. Cl. 768, 779–80, 524 F. 2d 693, 700 (1975); *Donemar, Inc.* v. *Molloy*, 169 N.E. 610, 611 (N.Y. 1930); *34 Hillside Realty Corp.* v. *Norton*, 101 N.Y.S. 2d 437, 440 (New York City Ct. 1950). The purpose of the bribery statute—the protection of the public from the corruption of public servants and the evil consequences of that corruption—will obviously be furthered by the recognition of a civil remedy. *See Kemler* v. *United States*, 133 F. 2d 235, 238 (1st Cir. 1942).

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[3] A few quotations will convey the judicial attitude toward subversion of an agent's loyalty.

"Any agreement or understanding by which his [a public servant's] judgment or duty conflicted with his private interest was corrupting in its tendency. • • • The conflict created [by the payment of secret commissions] between duty and interest is utterly vicious, unspeakably pernicious, and an unmixed evil."

City of Findlay v. *Pertz*, 66 F. 427, 435 (6th Cir. 1895), *quoted in United States* v. *Carter*, 217 U.S. 286, 307–08 (1910).

"Certainly, if unfaithful and disloyal conduct on the part of an agent is 'abhorrent to the letter and spirit of the law' and 'opposed to the policy of the law', it must logically follow that the conduct of a third party who aids an agent in the breach of his duty would fall into the same category."

Sears, Roebuck & Co. v. *American Plumbing & Supply Co.*, 19 F.R.D. 334, 344 (E.D. Wis. 1956).

"The [conflict of interest] statute is directed at an evil which endangers the very fabric of a democratic society, for a democracy is effective only if the people have faith in those who govern, and that faith is bound to be shattered when high officials and their appointees engage in activities which arouse suspicions of malfeasance and corruption."

United States v. *Mississippi Valley Generating Co.*, 364 U.S. 520, 562 (1961).

And so we come to the ultimate and precise issue—what sort of damage proof must the Government make when it sues the briber—from a rich judicial history stressing receptivity to the principal's request for monetary redress. Against that background, says the defendant-counterclaimant, it is enough to show the fact and amount of the bribes—nothing further need be alleged or proved by way of specific or direct injury.

We accept that position. Assuming (as we do) that the predicate for a non-statutory civil remedy is the probability that damage will flow from the giving of the bribe, we think it clear from common experience that such probability ordinarily accompanies the subversion of public officials. In normal course the briber deprives the Government of the loyalty of its employees, upon which the Government and the public must rely for the impartial and rigorous enforcement of government programs. *See, e.g., City of Findlay* v. *Pertz*, 66 F. 427, 434–35 (6th Cir. 1895). Bribery of officials can also cause a diminution in the public's confidence in the Government, upon which the Government must also rely. *See United States* v. *Mississippi Valley Generating Co.*, 364 U.S. 520, 562 (1961). The Government likewise incurs the administrative costs of firing and replacing the venal employees and the costs of investigation, all of which are compensable in fraud cases. *See United States* v. *Rex Trailer Co.*, 218 F. 2d 880, 884 (7th Cir. 1955), *aff'd on other grounds*, 350 U.S. 148 (1956).

These generalizations, supported by common sense and community experience, are made more concrete by the documentation in this particular case. According to the affidavit of Stanley Sirote, his assumption (by way of bribe) of a $30,000 loss of FHA Director Donald Carroll secured the promotions of two bribed FHA employees to positions involving the exercise of greater discretion with respect to mortgage insurance applications, in violation of the government's merit promotion regulations. *Cf. Hornsby* v. *Allen*, 326 F. 2d 605, 609–10 (5th Cir. 1964) (the preference of one applicant for a license over another equally qualified applicant as a result of a clandestine arrangement injures the disappointed applicant and the public, which has the right to expect adherence to standards and adjudication on the basis

of merit). The affidavit suggests other ways in which the plaintiffs benefited from the bribery at the probable expense of the Government: Money was paid one employee to assign the "right appraisers" (on about six occasions); an appraiser was paid $50 per house with respect to 30–60 houses; one employee was paid on three occasions for help on escrow problems; and another was paid "to work four of my FHA cases." The affidavit outlines several other payments to several other employees, payments extending as far back as seven or eight years before the execution of the document.

"Obviously no one would give or offer a bribe unless he expected to gain some advantage thereby." *Kemler* v. *United States*, 133 F. 2d 235, 238 (1st Cir. 1942). *See also Sears, Roebuck & Co.* v. *American Plumbing & Supply Co.*, 19 F.R.D. 334, 343 (E.D. Wis. 1956). Equally obviously, no businessman would continue a comprehensive program of bribes totaling thousands of dollars over a period of years, as Sirote did, if that program was not successful. Sirote's success had to come at the expense of the Government in some way, for plainly Sirote did not pay government employees to act in the federal interest. The plaintiffs, responsible as they are for Sirote's illegal conduct, cannot seriously contend that, because the Government has not offered to prove damages more specific than these, we must assume that the plaintiffs gained nothing and the Government lost nothing. *Cf. Donemar, Inc.* v. *Molloy*, 169 N.E. 610 (N.Y. 1930), in which the highest court of the state of New York said, "Penal Law * * * § 439, makes it a misdemeanor to give or receive money for the corrupt influencing of agents, employees, or servants. It would be a strange miscarriage of justice if the corrupting vendor and the corrupted agent of the vendee could retain the fruits of their crime and say that because the settlement was a fair one, the vendee sustained only nominal damages or no damages." *Id.* at 611.

It is an old maxim of the law that, where the fact of injury is adequately shown, the court should not cavil at the absence of specific or detailed proof of the damages. *See Petrovich* v. *United States*, 190 Ct. Cl. 760, 766–67, 421 F. 2d 1364, 1367 (1970). Here, the plaintiffs engaged in wrongful conduct that clearly hurt the Government. Significant elements of

that harm, such as the injury to the impartial administration of governmental programs, are not susceptible to an accurate monetary gauge. We should not deny the Government relief because Sirote managed to cause injury not readily traceable or measurable. Similarly, the Government's inability to attach an exact and provable dollar figure to the harm it sustained should not result in the effective exculpation of the plaintiffs. As the Supreme Court has said:

> Where the tort itself is of such a nature as to preclude the ascertainment of the amount of damages with certainty, it would be a perversion of fundamental principles of justice to deny all relief to the injured person, and thereby relieve the wrongdoer from making any amend for his acts.

Story Parchment Co. v. *Paterson Parchment Paper Co.*, 282 U.S. 555, 563 (1931); *cf. Donemar, Inc.* v. *Molloy*, *supra*. As between the briber and the bribee's employer, the risks of damage determination should fall on the former.

On this premise the amount of the bribe provides a reasonable measure of damage, in the absence of a more precise yardstick. That is, after all, the value the plaintiffs placed on their corruption of the defendant's employees; the other side of the coin is that the plaintiffs hoped and expected to benefit by more than the sum of the bribes. It is therefore fair to use that total as the measure of an injury which is probable in its impact but uncertain in its mathematical calculation. *See* D. DOBBS, REMEDIES 701–02 (1973); *cf. id.* at 684 n. 33; W. SEAVEY, AGENCY § 118 (1964). Moreover, there is support for this result in the views of the courts that have declared that all knowing participants in a scheme involving an agent's breach of duty may be held jointly liable to the principal for the agent's secret profits.[4] *B. F. Goodrich Co.* v. *Naples*, 121 F. Supp. 345, 348 (S.D. Cal. 1954); *Anderson* v. *Thacher*, 172 P. 2d 533, 545 (Cal. Dist. Ct. App. 1946); *Martin Co.* v. *Commercial Chemists, Inc.*, 213 So. 2d 477, 480 (Fla. Dist. Ct. App. 1968), *cert. denied*, 225 So. 2d 523 (Fla.

[4] If the third party is considered a joint tortfeasor with the agent and is liable for the secret profits as a joint tortfeasor (*Kinsbach Tool Co.* v. *Corbett-Wallace Corp.*, 160 S.W. 2d 509, 514 (Tex. 1942) (Texas law)), the third party can be held liable alone, not merely jointly, for the secret profits since the liability of a joint tortfeasor is joint and several. 59 AM. JUR. 2d *Parties* § 124 (1971).

1969); *Kinzbach Tool Co.* v. *Corbett-Wallace Corp.*, 160 S.W. 2d 509, 514 (Tex. 1942).[5] Of course, the Government cannot recover the bribes twice—once from the briber and again from the corrupted employee. But it is entitled to one such recovery.[6]

In the light of the preceding discussion, we can dispose rather briefly of two other, related arguments which plaintiffs raise. First, they say that the Government's cause of action is a penal one which cannot be pursued because the Government has not alleged any statutory basis for the claim and Sirote has already been punished under the only legislation providing a penalty for the wrongful conduct, 18 U.S.C. § 201(f). Second, they urge that, because Congress has dealt extensively with bribery and fraud by statute, this court's creation of a further bribery "penalty" would be inappropriate.

The first of these points fails because the Government's cause of action is not penal. It is remedial, designed to compensate the Government for the harm it has suffered. The Supreme Court has found congressional provisions for the award of $2,000 plus double damages in certain fraud statutes to be remedial, intended to assure the Government compensation where the full extent of damages is likely to be difficult to prove. *Rex Trailer Co.* v. *United States*, 350 U.S. 148, 151–54 (1956); *United States ex rel. Marcus* v. *Hess*, 317 U.S. 537, 549, 551–52 (1943). The key to whether a recovery would be penal is whether the claimed amount is unreasonable or excessive. *See Rex Trailer Co.* v. *United States*, *supra* at 154. The damages sought here—the amount of the bribes—are not excessive or unreasonable in view of the damages presumed to have resulted from the bribery, and they certainly are no less remedial than is an award in the amount of $2,000 plus double damages. Because the cause of action

[5] In two of these cases, *B. F. Goodrich* and *Anderson*, the courts held expressly that participants were liable even if they had not benefited from the transactions.

[6] If there be cases in which the facts are such that the Government suffered no injury from the bribe (or a harm less than the amount of the bribe), then we think those circumstances are likely to be so rare and exceptional that the briber should have the burden of demonstrating the lack of equivalent harm. That is most certainly not this case, and plaintiffs are far from showing that no damages, or lesser damages, were in fact incurred.

and the remedy are civil, the Government's use of them is not precluded by Sirote's prior criminal convictions; one act may give rise to both civil and criminal liability. *United States ex rel. Marcus* v. *Hess*, *supra* at 549; *United States* v. *Johnson*, 284 F. Supp. 273, 278 (W.D. Mo. 1968), *aff'd*, 410 F. 2d 38 (8th Cir.), *cert. denied*, 396 U.S. 822 (1969).

Similarly, the existence of extensive legislation governing bribery and fraud penalties does not rule out the Government's maintenance of a civil action based on a common law right. The Supreme Court and lower federal courts have granted common law (civil) remedies in numerous cases in which statutory remedies, sometimes elaborate networks of civil and criminal remedies, were available. *See United States* v. *Acme Process Equip. Co.*, 385 U.S. 138, 145 (1966); *United States* v. *Mississippi Valley Generating Co.*, 364 U.S. 520, 563 (1961); *United States* v. *Borin*, 209 F. 2d 145, 148 (5th Cir.), *cert. denied*, 348 U.S. 821 (1954); *United States* v. *Silliman*, 167 F. 2d 607, 611 (3d Cir.), *cert. denied*, 335 U.S. 825 (1948); *Pooler* v. *United States*, 127 F. 519 (1st Cir. 1904); *Brown* v. *United States*, 207 Ct. Cl. 768, 780, 524 F. 2d 693, 700 (1975). These courts have told us that a statutory remedy is not exclusive, and common law rights and remedies survive, unless Congress intended the legislative provision to be exclusive.[7] The mere existence of statutes establishing bribery and fraud penalties (and other sanctions) detracts in no way from the Government's right to a civil remedy of the kind available to private employers. Rather, the passage of legislation enlarging the government's arsenal of remedies strengthens the Government's case, because it establishes a statutory standard of conduct and evidences a strong policy against actions like those taken by Sirote. Our imposition of liability will implement that policy. *Cf. United States* v. *Mississippi Valley Generating Co.*, *supra* at 548–51, 563; *United States* v. *Acme Process Equip. Co.*, *supra* at 143, 146.

We hold, therefore, that the bribery for which plaintiffs are responsible was a wrong against the defendant for which

[7] Where Congress creates a right that did not exist at common law, the statutory remedy may be exclusive, in the absence of a common law right or remedy that could survive. *Pooler* v. *United States*, 127 F. 519, 520 (1st Cir. 1904).

Syllabus

the plaintiffs are liable in damages in the amount of the bribes paid. The first counterclaim is valid and plaintiffs' motion to dismiss it is denied. Defendant's cross-motion for partial summary judgment is granted to the extent that the plaintiffs are held liable for the bribes, gratuities and secret emoluments paid by or on behalf of plaintiffs to federal employees.[8] The amount of defendant's recovery will be determined under Rule 131(c).[9]

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526 F. 2d 1127

THE AETNA CASUALTY & SURETY COMPANY v. THE UNITED STATES

[No. 67-74. Decided December 17, 1975. Plaintiff's suggestion for rehearing *en banc* and motion for rehearing denied January 30, 1976] *

ON PLAINTIFF'S AND DEFENDANT'S MOTIONS FOR SUMMARY JUDGMENT

Contracts; rights and remedies of surety on performance and payment bonds; retained contract funds; Government right of setoff.—Plaintiff, a payment bond surety on ten contracts with the Post Office Department (POD) for construction and installation of mail handling systems at various post offices, seeks under the doctrine of equitable subrogation, to recover the unpaid contract balance ($77,094.61) held by the Government. Plaintiff paid debts owned by C (the contractor and the surety's principal) when C failed to meet its obligations to subcontractors and materialmen on said contracts. Plaintiff notified the POD of C's default and claimed entitlement to the unpaid contract balances. Defendant contends it has the right to set off against said amount certain obligations owed to it by C arising from a payment ($77,415.00) the Government made in satisfaction of a judgment against it in favor of C's subcontractor in connection with another POD contract (the Milwaukee contract) on which C had willfully failed to file payment and performance bonds and which POD terminated (after C's subcontractor had provided work and materials to C). Defendant also asserts the right to offset C's liability to it for the excess costs of reprocuring the Milwaukee contract. Plaintiff had no obligation under or connection with that contract. Plaintiff contends that POD's failure to require C to file the Miller Act payment and performance bonds rendered the Milwaukee contract illegal and that

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* We leave entirely open any question relating to the effect of limitations on the Government's counterclaim (*see* 28 U.S.C. § 2415). No such issue has been raised before us.

[9] *See* note 8 *supra*.

*On March 1, 1976 plaintiff filed a petition for writ of certiorari.

Syllabus

costs incurred by defendant thereunder cannot be claimed as an offset. It is *held* (1) the Milwaukee contract was not illegal; (2) that the Government is entitled to set off the amount of the judgmen paid in connection with the Milwaukee contract; and (3) that since the Government has enforceable rights against C under the Milwaukee contract, it is entitled to an offset representing the excess costs of reprocuring that contract. Since the two offsets exceed the amount of retained contract funds held by the Government, plaintiff is not entitled to recover. Defendant's motion for summary judgment is granted, plaintiff's motion for summary judgment is denied, and the petition is dismissed.

Contracts; formation of contract; Government contracts; validity of; failure to comply with statute or regulation.

[1] Upon the Government's acceptance of the contractor's bid, a valid contract came into existence and when the contractor failed to furnish the payment and performance bonds within the required period of time, he breached an existing and enforceable contract.

United States ⇐ 63

Setoff or offset; Government's right of setoff; generally.

[2] Even assuming a contract was illegal because the contractor failed to furnish the required payment and performance bonds, the Government's use of its own funds to satisfy a judgment against it in favor of the contractor's subcontractor, entitles the Government to collect against the contractor.

United States ⇐ 75(2)

Contracts; payments; unauthorized act of agent; Government not bound by.

[3] It is well-settled that the Government has inherent authority to recover sums illegally or erroneously paid, and that it cannot be estopped from doing so by the mistakes of its officers or agents. When a payment is erroneously or illegally made, it is in direct violation of article IV, section 3, clause 2, of the Constitution. Under such circumstances it is not only a lawful act but a duty of the Government to endeavor to recover the payment.

Estoppel ⇐ 62.2(4)

Contracts; sureties; rights and remedies of sureties; performance and payment bonds.

[4] The Miller Act requirement that the contractor file a payment bond is intended to protect subcontractors and materialmen on the particular contract for which the bond is required.

United States ⇐ 67(1)

Setoff or offset; Government's right of setoff; retained contract funds claimed by surety.

[5] The Government has the right to set off against retained contract balances otherwise due a payment bond surety who paid the contractor's (C's) laborers and materialmen on certain construction

Opinion of the Court

contracts, the payment the Government made in satisfaction of a judgment against it in favor of a subcontractor on another terminated construction contract awarded to C where it is shown that the surety did not execute either a payment or a performance bond for that contract. This right of setoff also included the excess costs of reprocuring the same contract (regardless of the questioned legality of the contract). Under the rationale of *United States* v. *Munsey Trust Co.*, 332 U.S. 234 (1947), the United States may set off against retained contract balances due a contractor on a construction contract, a debt owed the Government by the contractor arising out of a separate and independent transaction.

United States ⇐ 130(3)

Philip M. Cronin, attorney of record, for plaintiff.

Leslie H. Wiesenfelder, with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Before COWEN, *Chief Judge*, LARAMORE, *Senior Judge*, and BENNETT, *Judge*.

COWEN, *Chief Judge*, delivered the opinion of the court:

This case, before the court on the parties' cross-motions for summary judgment, involves a dispute between a Miller Act, 40 U.S.C. §§ 270a–d, payment bond surety and the Government over the surety's right to unpaid contract balances presently being held by the Government. The surety, Aetna Casualty & Surety Company (Aetna), claims that it is entitled to the entire amount of such balances ($77,094.61). Defendant, however, maintains that it has the right to set off against the contract balances certain obligations owed to the United States by the surety's principal, and that these offsets have a clear and absolute priority over any claim that the surety may have. For the reasons set forth below, we find that the Government is entitled to offsets in an amount that exceeds the unpaid contract funds. Accordingly, we grant defendant's cross-motion for summary judgment and dismiss plaintiff's petition.

The facts essential to a decision are not in dispute. In 1968 and 1969, the United States Postal Service (USPS), acting through its predecessor, the United States Post Office Depart-

ment (POD),[1] entered into ten contracts with the J. C. Corrigan Company (Corrigan) for the construction and installation of mail handling systems at various post offices. Plaintiff, Aetna, was the Miller Act payment and performance bond surety on each of the ten contracts.

In May 1971, upon learning that Corrigan had failed to meet its obligations to subcontractors and materialmen on those contracts, Aetna notified the POD of Corrigan's default and advised the POD that, by virtue of an assignment of the contract funds and Aetna's equitable rights as surety, Aetna was entitled to any contract funds remaining in the hands of the Government. As payment bond surety, Aetna has paid debts owed by Corrigan to the subcontractors and materialmen on eight of the contracts in the amount of $234,704.36.[2] The unexpended contract funds presently being held by USPS total $77,094.61. Aetna claims, under the doctrine of equitable subrogation, that it is entitled to these funds to reduce the losses it incurred in satisfying Corrigan's obligations to the subcontractors and materialmen. Defendant, however, maintains that under the rule laid down in *United States* v. *Munsey Trust Co.*, 332 U.S. 234 (1947), it has the right to set off against the contract balances certain obligations owed to it by Corrigan.

The primary offsets asserted by the Government arise out of a contract (No. 70–1–00698) that the POD awarded Corrigan on December 30, 1969, for the construction and installation of a mail handling system in the Milwaukee, Wisconsin, post office. Although Corrigan was required to file payment and performance bonds within 10 days from the award of that contract, none were ever filed. The POD, however, did not discover Corrigan's failure to file the bonds until April 1971. Thereafter, the POD determined that Corrigan's failure was willful and on May 10, 1971, terminated the contract.

A portion of the work on the Milwaukee contract was subcontracted by Corrigan to the Kennedy Electric Company

[1] USPS succeeded to the interest of the POD, under the terms of the Postal Reorganization Act, 84 Stat. 719 (1970), on July 1, 1971. All assets and liabilities of the POD were transferred to the USPS. *See* 39 U.S.C. § 2002.

[2] Aetna incurred no losses as a result of its performance bond obligations.

(Kennedy). On March 3, 1972, Kennedy brought suit against the USPS in the United States District Court for the District of Colorado to recover amounts due for work and materials provided Corrigan.[3] On December 7, 1973, the District Court entered judgment against USPS. *See Kennedy Elec. Co.* v. *United States Postal Service*, 367 F. Supp. 828 (D. Colo. 1973). That judgment, which was affirmed by the United States Court of Appeals for the Tenth Circuit, is now final. *See Kennedy Elec. Co.* v. *United States Postal Service*, 508 F. 2d 954 (10th Cir. 1974). The Government has paid $77,415.10 in full satisfaction of the judgment.

As its first offset, defendant claims that it has the right to offset the *Kennedy Electric* judgment against the unpaid contract balances. Plaintiff, on the other hand, contends that the Government's failure to require Corrigan to file payment and performance bonds rendered the Milwaukee contract illegal and, therefore, that any costs incurred by the Government thereunder cannot be claimed as an offset.

We reject plaintiff's contention for two reasons. In the first place, we are convinced that the Government's failure to obtain the required bond did not render the contract illegal. The better view, and the one which we adopt, is that upon the Government's acceptance of Corrigan's bid, a valid contract came into existence and that by failing to furnish the bonds within the required period of time, Corrigan breached an existing and enforceable contract. *United States* v. *Pennington*, 228 F. Supp. 374, 375 (E.D. La. 1964); *see United States* v. *Purcell Envelope Co.*, 249 U.S. 313, 319–20 (1919).

Secondly, even assuming the contract was illegal, we are of the opinion that defendant nevertheless is entitled to the offset which it now claims. The practical effect of the *Kennedy Electric* judgment was to require the Government to utilize its own funds to satisfy Corrigan's obligation to its subcontractor, Kennedy. As a result of its having paid Corrigan's obligation, the Government clearly has a claim against

[3] By this time, Corrigan was in bankruptcy. Since there was no surety from whom Kennedy could seek recovery, Kennedy was forced to proceed against USPS.

Corrigan that must be satisfied. Since Corrigan is now bankrupt, the only source of funds available from which defendant is able to satisfy this obligation is the contract funds it now holds.

It is a well-settled principle that the Government has inherent authority to recover sums illegally or erroneously paid, and that it cannot be estopped from doing so by the mistakes of its officers or agents. *See United States* v. *Wurts*, 303 U.S. 414, 415 (1938); *American Fidelity Fire Ins. Co.* v. *United States*, 206 Ct. Cl. 570, 580, 513 F. 2d 1375, 1381 (1975); *Fansteel Metallurgical Corp* v. *United States*, 145 Ct. Cl. 496, 500, 172 F. Supp. 268, 270 (1959). As this court recognized in *Fansteel Metallurgical Corp.* v. *United States*, 145 Ct. Cl. at 500, 172 F. Supp. at 270:

> [W]hen a payment is erroneously or illegally made it is in direct violation of article IV, section 3, clause 2, of the Constitution. [case citation.] Under these circumstances it is not only lawful but the duty of the Government to sue for a refund thereof * * *.

Defendant's contention that, under the circumstances of this case, it is entitled to recover the losses that it has incurred in satisfying the *Kennedy Electric* judgment from the funds earned by Corrigan on its other contracts with the Government, is clearly consistent with these cogently expressed mandates.

Plaintiff appears to argue that, since the costs incurred by defendant in satisfying the *Kennedy Electric* judgment result from defendant's failure to comply with the Miller Act, equity should not permit defendant to recoup its losses by setting them off against the legitimate claims of a surety. Plaintiff, however, derives no legal or equitable rights from any action taken or not taken in connection with the unbonded Milwaukee contract. Aetna had no relationship to, nor participation in, that contract. The Miller Act requirement that the contractor file a payment bond is intended to protect subcontractors and materialmen on the particular contract for which the bond is required. *See Kennedy Elec. Co.* v. *United States Postal Service*, 508 F. 2d 954, 957 (10th

Cir. 1974); *United States* v. *Aetna Cas. & Sur. Co.*, 480 F. 2d 1095, 1100 (8th Cir. 1973); *J. J. Henry Co.* v. *United States*, 188 Ct. Cl. 39, 51 n. 7, 411 F. 2d 1246, 1252–53 n. 7 (1969). Plaintiff was not a surety on the Milwaukee contract and has no right of subrogation or other equitable right arising out of the rights of those who furnished labor and material for the performance of that contract. Thus, for the reasons set forth above, we conclude that the defendant is entitled to its first offset.[4]

As a second offset, defendant claims that it has the right to withhold $58,691 to cover Corrigan's liability to defendant for the excess costs of reprocuring the Milwaukee contract.[5] Plaintiff apparently relies again on its illegality argument to defeat defendant's claim. However, as indicated above, defendant has enforceable rights against Corrigan under the Milwaukee contract. Accordingly, defendant is entitled to an offset representing the excess costs of reprocuring the Milwaukee contract. *See United States* v. *Pennington*, 228 F. Supp. 374, 375 (E.D. La. 1964); *Adelhardt Constr. Co.* v. *United States*, 123 Ct. Cl. 456, 459–60, 107 F. Supp. 845, 846 (1952).

Having determined that defendant is entitled to offsets in an amount that exceeds the contract funds remaining in defendant's hands, we conclude that plaintiff is not entitled to recovery. Accordingly, it is ordered that defendant's cross-motion for summary judgment is granted; plaintiff's motion for summary judgment is denied, and plaintiff's petition is dismissed.

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[4] Defendant claims that it is entitled to offset the full amount of the *Kennedy Electric* judgment. There is some question, however, as to whether defendant is entitled to offset that entire amount or whether that amount must be reduced by any funds from the Milwaukee contract remaining in defendant's hands. The District Court opinion in *Kennedy Electric* indicates that $35,739.47 remains in defendant's hands. *See* 367 F. Supp. at 832. However, since plaintiff has only contested defendant's right to the offset, and not the amount thereof, we find on the record before us that the Government is entitled to offset the entire amount. Even if we were to take into account the $35,739.47, and reduce defendant's offset accordingly, the reduction would not be enough to affect the overall result which we reach.

[5] The amount of this offset is established by the contracting officer's final decision, dated January 14, 1975. The decision was not appealed.

Syllabus

526 F. 2d 1121

CAROLINE BUSH EMENY, ET AL. v. THE UNITED STATES

[No. 317-66. Decided December 17, 1975]

ON THE PROOFS

Eminent domain; taking; just compensation; reasonable attorney, appraisal and engineering fees; helium storage in Bush Dome.— In a decision dated July 16, 1969 (188 Ct. Cl. 1024, 412 F. 2d 1319), this court held that the right to use Bush Dome, located on property owned by plaintiffs, for storage of helium produced elsewhere was vested in plaintiffs and not in defendant under certain leases granting to defendant the right to produce the helium-rich natural gas contained in the Bush Dome. On October 26, 1973 the court entered an order declaring that plaintiffs were entitled to recover as just compensation for the taking $231,880 plus a sum computed at the rate of 4% per year on said figure from January 5, 1963 to the time of payment. The court remanded the case to the trial judge for determination of the amount of reasonable attorney, appraisal and engineering fees actually incurred by plaintiffs because of the proceedings in this case, pursuant to 42 U.S.C. § 4654(c). It is *held* (1) that the language of Sec. 4654(c) precludes inclusion in an award reimbursement for expenses incurred before deciding to file suit in this court; (2) that expenses covering attorneys' fees paid to associate counsel who reviewed papers prepared by the principal attorneys, under the circumstances here are not reasonable and therefore not allowable under Sec. 4654(c); and (3) that the other litigation expenses actually incurred by plaintiffs, although much larger than the value of the property rights as determined by the court, are reasonable and allowable in view of the unusual complications involved in the litigation. Plaintiffs are entitled to recover $341,346.60 as reimbursement for reasonable costs, disbursements and expenses (including reasonable attorney, appraisal and engineering fees actually incurred because of this proceeding, but not for such costs, disbursements and expenses incurred after April 17, 1975), in addition to recovering under the court's order of October 26, 1973, as amended, the sum of $221,880 plus an amount computed at the rate of 4% per annum on $221,880 from January 5, 1963 to the time of payment; and judgment is entered for the identified plaintiffs against defendant in the total sum of $563,226.60, plus an amount computed at the rate of 4% per annum on $221,880 from January 5, 1963 to the time of payment.

Eminent domain; just compensation; litigation expenses; prelitigation.

[1] Under the plain language of 42 U.S.C. § 4654(c), this court is precluded from including in an award for the taking of property

by a Federal agency reimbursement for expenses incurred before deciding to institute proceedings in the Court of Claims under 28 U.S.C. § 1491. Allowance of pre-litigation expenses would require an amendment of the governing statutory provisions, and this is beyond the power of the court.

Eminent Domain ⟸ 302

Eminent domain; just compensation; litigation expenses; attorney's fees (duplicate counsel).

[2] 42 U.S.C. § 4654(c) authorizes reimbursement only for "reasonable" expenses actually incurred because of a proceeding under 28 U.S.C. § 1491 for the taking of property by a Federal agency. Although the present case is unusually complicated, for purposes of Sec. 4654(c) it is not reasonable to require defendant to defray the cost of fees paid to associate counsel who reviewed the work of other experienced, competent and highly paid principal attorneys.

Eminent Domain ⟸ 316

Eminent domain; just compensation; litigation expenses.

[3] Although the amount of litigation expenses (after elimination of reviewing counsels' fees) claimed by plaintiffs is larger than this court's valuation of the property rights involved in the litigation, such expenses, including those made after the court rendered its decisions on ownership of the gas storage capacity of Bush Dome and on the value of the property rights taken by defendant, are reasonable and authorized by the language of 42 U.S.C. § 4654(c), in view of the extraordinarily complicated legal and technical issues involved, requiring utilization of the services of experienced, highly skilled, and expensive attorneys and technical experts.

Eminent Domain ⟸ 316

Richard A. Baenen, attorney of record, for plaintiffs. *Thomas E. Wilson* and *Wilkinson, Cragun & Barker*, of counsel.

Hugh Crean, with whom was *Assistant Attorney General Wallace H. Johnson*, for defendant. *Floyd L. France*, of counsel.

Before DURFEE, *Senior Judge*, SKELTON and BENNETT, *Judges*.

PER CURIAM: This case comes before the court on exceptions by the parties to the recommended decision filed April 17, 1975, by Senior Trial Judge Mastin G. White pursuant to Rule 134(h), having been submitted and considered on the briefs and oral argument of counsel. Since the court agrees with the recommended decision, as hereinafter set

forth*, it hereby affirms and adopts the same as the basis for its judgment in this case. It is therefore concluded as a matter of law that the following plaintiffs are entitled to recover $341,346.60 as reimbursement for reasonable costs, disbursements and expenses (including reasonable attorney, appraisal and engineering fees, actually incurred because of this proceeding, but not for such costs, disbursements and expenses incurred after April 17, 1975), in addition to recovering under the court's order of October 26, 1973, as amended by the order of November 2, 1973, the sum of $221,880, plus an amount computed at the rate of 4 percent per annum on $221,880 from January 5, 1963, to the time of payment, as just compensation for the taking of their property; and judgment is entered for them against the defendant in the total sum of $563,226.60, plus an amount computed at the rate of 4 percent per annum on $221,880 from January 5, 1963 to the time of payment:

Caroline Bush Emeny, Individually and as Trustee,
Francis T. O'Brien, Trustee,
Frederick L. Emeny, Trustee,
Elizabeth Claire Bivins Childers, Trustee,
First National Bank of Amarillo, Trustee,
Iris F. Prescott,
Estelle F. Marsh, Executrix of the Estate of Stanley Marsh, Jr.,
Tom F. Marsh,
Stanley Marsh, III,
Michael C. Marsh,
Mary Taggart Emeny, Trustee,
Gwendolyn O'Brien Marsh, Trustee,
Caroline O'Brien Sobieski, Trustee, and
Caroline Emeny Wagley, Trustee.

OPINION OF TRIAL JUDGE

WHITE, *Senior Trial Judge:* This is the concluding phase of a controversy which has involved complex issues of fact and law, has extended over a prolonged period of time, and has been quite expensive for all concerned.[1] The purpose of

*Whereas the court adopts the trial judge's separate findings of fact, which are set forth in his report filed April 17, 1975, they are not printed herein since such facts as are necessary to the decision are contained in his opinion.

[1] The plaintiffs' expenses are summarized in the findings of fact. Although the record does not contain any specific data on the expenses incurred by the Government in connection with the controversy, the total of such expenses would undoubtedly be a large amount.

the present undertaking is to determine the plaintiffs' allowable litigation expenses under the provisions of 42 U.S.C. § 4654(c).

Section 4654(c) provides in pertinent part as follows:

> (c) The court rendering a judgment for the plaintiff in a proceeding brought under section * * * 1491 of Title 28, awarding compensation for the taking of property by a Federal agency, * * * shall determine and award * * * to such plaintiff, as a part of such judgment * * *, such sum as will in the opinion of the court * * * reimburse such plaintiff for his *reasonable* costs, disbursements, and expenses, including *reasonable* attorney, appraisal, and engineering fees, actually incurred *because of such proceeding*. [Emphasis supplied.]

The several plaintiffs are the owners of 23 contiguous tracts of land which contain a total of 13,867.5 acres and are situated in Potter County, Texas. These 23 tracts of land overlie a large subterranean geological structure, or underground dome, commonly known as the Bush Dome.

In its natural state, the Bush Dome contained a valuable deposit of natural gas having an unusually high helium content. Many years ago, the defendant—represented by the Helium Activity of the Bureau of Mines, Department of the Interior—acquired from the plaintiffs (or their predecessors in interest) the ownership of the native gas deposit in the Bush Dome. During the intervening years, the defendant has removed billions of cubic feet of the helium-rich natural gas from the Bush Dome and, in the national interest, has extracted the helium from the other constituents of the natural gas before disposing of the residue for commercial purposes.

The controversy out of which this litigated case arose had its origin on January 5, 1963, when the Helium Activity began to inject foreign crude helium (*i.e.*, crude helium extracted from natural gas produced elsewhere) into the Bush Dome. Both the plaintiffs and the defendant claimed the ownership of the gas storage capacity in the Bush Dome that had been made available as a result of the defendant's previous actions in removing native natural gas from the Bush Dome as part of the national program for the production of helium.

As the plaintiffs and the defendant were unable to resolve their disagreement through negotiations, the plaintiffs instituted an action in this court on August 30, 1966, by filing a petition under the provisions of section 1491 of Title 28, United States Code.

In a decision dated July 16, 1969 (188 Ct. Cl. 1024, 412 F. 2d 1319), the court held that the right to use the Bush Dome for the storage of helium produced elsewhere was vested in the plaintiffs, and not in the defendant. Further steps were then taken to determine the value of the property rights which the defendant had taken from the plaintiffs; and on October 26, 1973, the court entered an order declaring that the plaintiffs were entitled to recover the sum of $221,880, plus an amount computed at the rate of 4 percent per annum on $221,880 from January 5, 1963, to the time of payment, as just compensation for the taking by the defendant of the gas storage right in the Bush Dome and the incidental right to use so much of the surface of the lands containing the Bush Dome as may be reasonably necessary in the operation of a gas storage reservoir for foreign gas. The award included $208,012.50 for the taking of the gas storage right and $13,867.50 for the taking of the incidental right in the surface of the plaintiffs' lands.

Thereafter, on motion of the plaintiffs, the court remanded the case to the trial judge on January 4, 1974, for a determination to be made concerning "the amount of the reasonable attorney, appraisal, and engineering fees actually incurred by plaintiffs because of the proceedings in this case, pursuant to 42 U.S.C. § 4654(c)." [2] A trial for the reception of evidence on the subject matter of the remand was held; and the parties subsequently utilized the customary post-trial procedures by filing requested findings of fact and briefs.

Pre-Litigation Expenses

A considerable period elapsed between the time when the defendant began to inject foreign crude helium into the Bush Dome on January 5, 1963, and the time in 1966 when the

[2] The remand order also directed the trial judge "to determine and list the names of plaintiffs who are entitled to recover."

plaintiffs concluded that their controversy with the defendant over the right to store gas in the Bush Dome would have to be litigated by the institution of an action in the Court of Claims under 28 U.S.C. § 1491. During the intervening period, the plaintiffs, at considerable expense, sought and obtained advice and assistance from several prominent law firms located in Amarillo, Texas, in Austin, Texas, in Cleveland, Ohio, and in Washington, D.C., and from prominent petroleum engineering firms located in Amarillo, Texas, in Dallas, Texas, and in Tulsa, Oklahoma. The plaintiffs were endeavoring during this period to ascertain the nature and extent of their property right in the gas storage capacity of the Bush Dome, and to obtain from the Government, through negotiations, a recognition of such right.

One of the questions to be decided at the present time is whether the plaintiffs are entitled to reimbursement under 42 U.S.C. § 4654(c) for the pre-litigation expenses, amounting to $40,826.62. The plaintiffs, quite naturally, argue that this question should be answered in the affirmative, while the defendant—not unexpectedly—contends that a negative answer to the question is required.

It is my conclusion that the plain language of 42 U.S.C. § 4654(c) precludes the court from including in its award to the plaintiffs any reimbursement for expenses incurred by the plaintiffs before they decided to file suit in the Court of Claims under 28 U.S.C. § 1491.

It will be recalled that the governing statutory provision, previously quoted in this opinion, authorizes reimbursement for those expenses—and only for those expenses—incurred "because of such proceeding"; and, under the ordinary rules of syntax, the quoted phrase obviously refers back to "a proceeding *brought under section * * * 1491 of Title 28 * * **" for the taking of property by a Federal agency" (emphasis supplied). The plaintiffs' expenses in connection with this controversy during the time when the plaintiffs were endeavoring to ascertain the nature and extent of their property right in the gas storage capacity of the Bush Dome, and trying to obtain a recognition of such right from the Government through negotiations, certainly were not incurred by the plaintiffs "because of" the proceeding which they subse-

quently instituted in this court under 28 U.S.C. § 1491 after the failure of the negotiations with the Government.

Thus, an allowance of the plaintiffs' pre-litigation expenses would require an amendment of the governing statutory provision, and this is beyond the power of the court.

Litigation Expenses

The period of the litigation in this case was quite lengthy, extending over more than 8 years, and the plaintiffs' expenses during such period in connection with the case were impressively large, totaling $376,583.68.

It is established by the record that these expenses were "actually incurred" by the plaintiffs, and that they were incurred "because of" the proceeding under 28 U.S.C. § 1491. The parties are in dispute, however, over the question of whether all of these litigation expenses are properly allowable under the governing statutory provision.

It will be recalled that 42 U.S.C. § 4654(c) authorizes reimbursement only for "reasonable" expenses that are "actually incurred because of" a proceeding brought under 28 U.S.C. § 1491 for the taking of property by a federal agency. The defendant takes the position in the present case that not all of the plaintiffs' actual expenses in connection with this litigation can properly be regarded as "reasonable" charges against the Government under the pertinent statutory provision. The defendant particularly emphasizes in this respect the plaintiffs' tendency to engage duplicate sets of lawyers, and also the disproportionate relationship (in the defendant's view) between the amount of the plaintiffs' litigation expenses ($376,583.68) and the value ($221,880, as determined by the court) of the property rights which the defendant had taken and for which the plaintiffs were endeavoring to obtain just compensation in the litigation.

Duplicate sets of lawyers were retained and paid by the plaintiffs throughout most of the litigation period. From the inception of the litigation in 1966 until January 18, 1969, the plaintiffs' principal attorney was Will Wilson, of Austin, Texas, and associated with him was Joe A. Osborn, also of Austin, Texas. Messrs. Wilson and Osborn were prominent Texas lawyers. Mr. Wilson had served as the Attorney Gen-

eral of Texas and as an Associate Justice of the Supreme Court of Texas. Mr. Osborn had served as an Assistant Attorney General of Texas, in the Lands Division of the Attorney General's Office. Mr. Wilson withdrew from the case on January 18, 1969, in order to accept a federal appointment as an Assistant Attorney General in the U.S. Department of Justice. He was succeeded as the plaintiffs' principal attorney by another prominent Texas lawyer, Gaynor Kendall, who had previously served as an Assistant Attorney General of Texas, as a Visiting Professor of Law at the University of Texas Law School, and as a member of the Board of Directors of the Texas Bar Association. Mr. Osborn was associated with, and assisted, Mr. Kendall in the conduct of the litigation. Mr. Kendall's role as the plaintiffs' principal attorney continued until October 1969. First Mr. Wilson and then Mr. Kendall, with the assistance of Mr. Osborn, handled the case in a highly competent manner and were successful in persuading the court (188 Ct. Cl. 1024, 412 F. 2d 1319) that the plaintiffs, and not the defendant, had the right to use the Bush Dome for the storage of helium produced elsewhere.

Notwithstanding the prominence and competency of Messrs. Wilson, Kendall, and Osborn, the plaintiffs deemed it advisable to retain the services of the outstanding Cleveland, Ohio, law firm of Jones, Day, Cockley & Reavis, and of that firm's Washington, D.C., branch operating under the name of Reavis, Pogue, Neal & Rose, for the purpose of rendering assistance in connection with the litigation. Such assistance consisted principally of reviewing and commenting upon papers prepared by Messrs. Wilson and Osborn, or Messrs. Kendall and Osborn, for filing with the court. For such services, the plaintiffs paid Jones, Day, Cockley & Reavis, and its Washington branch, a total of $27,818.73, while paying the principal attorneys, Messrs. Wilson, Kendall, and Osborn, a total of $39,586.41 over the same period of time.

In October 1969, after the court had decided the issue of liability in favor of the plaintiffs, Conan Cantwell, a member of the prestigious Dallas, Texas, law firm of Jackson, Walker, Winstead, Cantwell & Miller, became the plaintiffs' principal attorney in the proceedings for the determination of the value

of the property rights taken by the defendant. Mr. Cantwell had previously distinguished himself in the field of real property and oil and gas law, and was Chairman of the Oil and Gas Institute of the Southwestern Legal Foundation. In the conduct of this litigation, Mr. Cantwell was assisted by other members of his firm, particularly A. W. Walker, Jr., the firm's most senior partner, and Jack Pew, Jr. Mr. Walker was a former Professor of Law at the University of Texas and a former President of the Texas Petroleum Council. Mr. Cantwell, with the assistance of other members of his firm, handled the case for the plaintiffs with great thoroughness and skill throughout the proceedings for the determination of the value of the property rights taken by the defendant.

In June 1971, while Conan Cantwell was in charge of the case for the plaintiffs, the latter retained the prominent Washington, D.C., law firm of Wilkinson, Cragun & Barker to render assistance to Mr. Cantwell and his firm in the valuation proceedings. Such assistance consisted principally of reviewing papers prepared by Mr. Cantwell and his firm for filing with the court. For such services, the plaintiffs paid Wilkinson, Cragun & Barker the sum of $7,418.35, while paying the principal attorneys, Jackson, Walker, Winstead, Cantwell & Miller, a total of $155,350.21.

The plaintiffs' tendency to retain the services of a duplicate set of attorneys, while being represented by another highly competent set of attorneys as principal counsel, was apparently due to the plaintiffs' rather extravagant idea of the value of the property rights taken by the defendant—the plaintiffs asked for a judgment in the amount of $2,330,911 for the property rights, not including any litigation expenses—and the plaintiffs' determination that every possible effort would be made, first, to have the validity of their claim recognized and, second, to have their exaggerated idea of value accepted.

The plaintiffs' generous strategy with respect to the engagement of attorneys may have been reasonable from their standpoint, in view of the objectives which they were seeking to achieve. On the other hand, when the matter is considered from the standpoint of requiring the defendant to

reimburse the plaintiffs for litigation expenses, the conclusion is inescapable that there was a superabundance of attorneys involved in the proceedings on the plaintiffs' side. For the purposes of 42 U.S.C. § 4654(c), it does not seem "reasonable" to require the defendant (*i.e.*, the taxpayers of the country) to defray the cost of the plaintiffs' strategy in having one set of experienced, competent, and highly paid attorneys review the work of another set of experienced, competent, and highly paid attorneys.

It is my opinion, therefore, that the expense items of $27,818.73 and $7,418.35 for attorneys' fees paid to reviewing counsel are not allowable under 42 U.S.C. § 4654(c).

With the $27,818.73 and the $7,418.35 items eliminated, there still remains in the claim the impressive figure of $341,346.60, representing litigation expenses incurred by the plaintiffs because of the litigation over the Bush Dome. The remaining figure is, of course, much larger than the value ($221,880, as determined by the court) of the property rights over which the plaintiffs were litigating with the defendant.

This proceeding—to determine, first, whether the plaintiffs or the defendant owned the gas storage capacity in the Bush Dome, and, second, to determine the value of the property rights in question—has involved extraordinarily complicated legal and technical issues. Throughout the proceeding, the defendant has sought, with great skill on the part of its exceedingly able counsel and technical experts, to establish the proposition that the plaintiffs were not entitled to recover anything in the litigation, either because the defendant owned the gas storage capacity in the Bush Dome or because such capacity, if owned by the plaintiffs, was unusable by the plaintiffs as a practical matter, and was therefore worthless, by virtue of the defendant's ownership of the native gas remaining in the Bush Dome.

In view of the unusual complications that have been involved in the litigation, and the defendant's adamant position as mentioned in the preceding paragraph, the plaintiffs were certain entitled—and, indeed, were required as a practical matter—to utilize the services of experienced, highly skilled, and, therefore, expensive attorneys and technical experts. There is nothing in the record to indicate that the attorneys

in charge of the case for the plaintiffs, or the technical experts involved in the case on the plaintiffs' side, charged the plaintiffs for any supposed work not actually performed, or that they did any work not reasonably required because of the complexities of the case, or that they charged the plaintiffs any larger fees than they would have charged other clients for the same amounts of work.

Accordingly, it is my opinion that, under the unusually complicated circumstances of this case, the expenses amounting to $341,346.60, actually incurred by the plaintiffs because of the proceeding under 28 U.S.C. § 1491, should be regarded as "reasonable" and allowable for the purposes of 42 U.S.C. § 4654(c).

The figure of $341,346.60, representing the plaintiffs' allowable litigation expenses, includes amounts totaling $69,240.15 expended by the plaintiffs in establishing their entitlement to recover litigation expenses and the amount of such expenses. These expenditures were made after the court had rendered the decision of July 16, 1969, in favor of the plaintiffs on the question of the ownership of the gas storage capacity in the Bush Dome and the decision of October 26, 1973, on the value of the property rights taken by the defendant. Nevertheless, the plaintiffs' post-decisional expenditures to establish their right to recover litigation expenses and the amount thereof were made "because of" the proceeding brought under 28 U.S.C. § 1491 for the taking of their property by the defendant. Consequently, reimbursement for such expenditures as a part of the judgment rendered in the proceeding is authorized by the language of 42 U.S.C. § 4654(c).

When the allowable litigation expenses in the amount of $341,346.60 are added to the sum of $221,880 previously determined by the court to be the value of the property rights taken by the defendant, it appears that the plaintiffs' judgment should be in the total amount of $563,226.60.

CONCLUSION OF LAW

Upon the findings of fact and the opinion, which are adopted by the court and made a part of the judgment herein, the court concludes as a matter of law that the plain-

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tiffs Caroline Bush Emeny, Individually and as Trustee, Francis T. O'Brien, Trustee, Frederick L. Emeny, Trustee, Elizabeth Claire Bivins Childers, Trustee, First National Bank of Amarillo, Trustee, Iris F. Prescott, Estelle F. Marsh, Executrix of the Estate of Stanley Marsh, Jr., Tom F. Marsh, Stanley Marsh, III, Michael C. Marsh, Mary Taggart Emeny, Trustee, Gwendolyn O'Brien Marsh, Trustee, Caroline O'Brien Sobieski, Trustee, and Caroline Emeny Wagley, Trustee, are entitled to recover $341,346.60 as reimbursement for reasonable costs, disbursements, and expenses, including reasonable attorney, appraisal, and engineering fees, actually incurred because of this proceeding up to April 17, 1975, in addition to recovering, under the court's order of October 26, 1973, as amended by the order of November 2, 1973, the sum of $221,880, plus an amount computed at the rate of 4 percent per annum on $221,880 from January 5, 1963, to the time of payment, as just compensation for the taking of their property. Plaintiffs are not entitled to recover for such costs, disbursements, and expenses incurred after April 17, 1975. It is therefore adjudged and ordered that the said plaintiffs recover of and from the United States the total sum of five hundred sixty-three thousand two hundred twenty-six dollars and sixty cents ($563,226.60), plus an amount computed at the rate of 4 percent per annum on $221,880 from January 5, 1963, to the time of payment.

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527 F. 2d 1392

KNAPP KING-SIZE CORP. and KNAPP BROTHERS SHOE MANUFACTURING CORP. v. THE UNITED STATES

[Nos. 9-73 and 203-73. Decided December 17, 1975]

OPINION

Taxes; corporate income tax; purchase of business; basis of property received in liquidation; amount attributable to inventory.— Plaintiffs seek refund of Federal corporate income taxes and interest paid by them for years 1967 and 1968. On December 20, 1966 Knapp Bros. purchased all of the outstanding stock of King Size and 10 months later on October 31, 1967 Knapp Bros. liquidated King-Size and took over all of its assets. Pursuant to Sec. 334(b)(2) of the Internal Revenue Code of 1954, Knapp's adjusted basis for

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the stock became its basis for the assets after the liquidation. The parties having agreed upon such adjusted basis as of October 31, 1967 and upon the allocation of basis to the assets other than inventory and goodwill, at issue is determination of the allocation to inventory. It is *held* in light of the Treasury's own interpretation of Treas. Reg. § 1.334–1 and for purposes of this case, plaintiffs are entitled to use as their allocated basis for the King-Size inventory its fair market value as of October 31, 1967 irrespective of the fact that King-Size had in the interim between December 20, 1966 and October 31, 1967 disposed of the December 20, 1966 inventory and purchased new inventory. It is *held* further that the fair market value of such inventory is not determinable from the aggregate retail price alone but should take into account as well the replacement cost at wholesale and a fair return to the buyer in the light of the risks and costs of disposition. Plaintiffs are entitled to recover, the amount of recovery to be determined in further proceedings under Rule 131(c).

Taxes; Treasury Regulations; construction and operation; adjusted basis of property received in liquidation of transferor.

[1] Having been authorized to prescribe regulations in connection with a complicated statute such as Sec. 334(b)(2) of the 1954 Internal Revenue Code regarding the adjusted basis of stock and other items received in liquidation of a transferor, the Secretary of the Treasury's authority is not merely interpretative but such authority gives him discretion in the application of his expert knowledge of the problems the statute was designed to meet.

Internal Revenue ⇐ 157

Taxes; Treasury Regulations; reenactment of statute without substantive change.

[2] Where long-standing Treasury Regulations have survived repeated reenactments of revenue laws without substantive change, they are deemed to have been approved by Congress and to have the force of law.

Internal Revenue ⇐ 172

Taxes; income tax; corporate distributions and adjustments; corporate liquidation; basis of property received in liquidation; exception; fair market value.

[3] Where A purchased all of the outstanding stock of B and 10 months later A liquidated B and took over all of its assets, under Sec. 334(b)(2) of the Internal Revenue Code of 1954 such an acquisition and liquidation is a purchase of the assets at the price which the acquiring company paid for the stock, with adjustments for the intervening financial results of operations during the 10-month period. In light of Treas. Reg. § 1.334–1, the basis to A of the inventory acquired on liquidation of B is its fair market value as of the date of liquidation, irrespective of the fact that B had,

during said 10-month period, disposed of the original inventory and purchased new inventory.

Internal Revenue ⇐ 365

Taxes; valuation of assets; fair market value of stock; generally.

[4] Determination of fair market value is basically a factual decision, no matter how complicated the reasoning process involved.

Internal Revenue ⇐ 438

Taxes; income tax; corporate distributions and adjustments; corporate liquidations; basis of property received in liquidation; fair market value; factors to be considered.

[5] The fair market value of inventory acquired in an intercorporate stock purchase and liquidation, is not measurable by the aggregate retail price alone but should take into account as well the replacement cost at wholesale and a fair return to the buyer in the light of the risks and costs of disposition.

Internal Revenue ⇐ 439

Chester M. Howe, attorney of record, for plaintiff.

Allan C. Lewis, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Theodore D. Peyser*, of counsel.

Before COWEN, Chief Judge, SKELTON and BENNETT, *Judges*

PER CURIAM: These cases come before the court on plaintiffs' motion, filed September 25, 1975, requesting that the court adopt, as the basis for its judgment in these cases, the recommended decision of Trial Judge Philip R. Miller, filed May 9, 1975, as modified by the Supplemental Opinion, filed August 13, 1975, pursuant to Rule 134(h). Both opinions have now been consolidated in one opinion and defendant has filed no notice of intention to except thereto. Upon consideration thereof, without oral argument, since the court agrees with the recommended decision as hereinafter set forth, it hereby adopts the basis for its judgment in this case.

It is therefore ordered and concluded, as a matter of law, that the court has jurisdiction of these cases and that plaintiffs are entitled to recover. Judgments are entered for plaintiffs to that effect with the amount of their recoveries to be determined in further proceedings pursuant to Rule 131(c); and

It is further ordered that the order issued November 21, 1975, is, in view of the issuance of this opinion per curiam, hereby withdrawn.

OPINION OF TRIAL JUDGE

MILLER, *Trial Judge:* These are suits for refund of federal corporate income taxes and interest paid by Knapp Brothers Shoe Manufacturing Corp. (Knapp Bros.) and its successor in interest, Knapp King-Size Corp. (Knapp), of Brockton, Massachusetts, in the sums of $779,460 and $58,773, for the years 1967 and 1968. The only question at issue is the determination of the portion of the purchase price paid for an entire business which may be attributed to the inventory.

On December 20, 1966, Knapp Bros. purchased all of the outstanding stock of King-Size Inc. (King-Size) from its stockholders. Ten months later, on October 31, 1967, Knapp Bros. liquidated King-Size and took over all of its assets in its own name. For the calendar year 1967, Knapp Bros. filed a consolidated income tax return with King-Size, including therein all income and deducting all costs and expenses from the operation of King-Size prior to its liquidation.

Section 334(b)(2) of the Internal Revenue Code of 1954 treats such an acquisition and liquidation as a purchase of the assets at the price which the acquiring company paid for the stock, with adjustments for the intervening financial results of operations during the 10-month period. The adjusted basis as of October 31, 1967, is agreed to be $5,347,725. The parties have also agreed that the proper allocation of basis to the assets other than the inventory and goodwill is $755,761. This leaves for determination only the relative portions of the remaining $4,591,964 to be attributed to the inventory and goodwill. The parties have further agreed that whatever value is determined for the inventory the residue is allocable to goodwill. The portion attributed to inventory represents the cost of goods sold for purposes of determining Knapp Bros.' income from the sale of merchandise for the years at issue.

Prior to December 20, 1966, Knapp Bros. was exclusively in the shoe business, both as a manufacturer and distributor, selling through a chain of retail stores, at wholesale and by mail order. King-Size was also located in Brockton and was

exclusively a retail distributor of men's apparel and accessories, 92 percent of its sales being by mail order. It was the sole national mail-order distributor dealing exclusively in wearing apparel and accessories for men who were above average in height and weight. Its customers for the most part were over 6 feet 2 inches in height and weighed in excess of 200 pounds. It did no manufacturing but purchased all of its merchandise from standard manufacturers, modifying their specifications, however, to suit the needs of its unusual clientele. King-Size had a 600,000 name customer list which it had amassed by soliciting applicants for its catalogs through advertising in national periodicals at an average cost of about $3 per name. The executives of Knapp Bros. were of the view that King-Size's mail-order trade for large sized men's apparel could be used to complement Knapp Bros. own mail order shoe business.

The negotiations for the purchase of the King-Size stock began in January 1966 and culminated in a verbal agreement by September 1966. There were no negotiations with respect to the price of specific assets nor any attempt to put values on such assets. The price was essentially arrived at by capitalizing King-Size's earnings at a 10 percent rate. A basic $3,700,000 price represented 10 times the earnings for King-Size's fiscal year ending October 31, 1966; but it was subject to increases up to $4,500,000 if in any of the 3 ensuing years the earnings increased to levels that would warrant such price upon application of the same multiple. In fact the earnings did increase and the aggregate purchase price did become $4,500,000. The kinds of adjustments which increased the basis to $5,347,725 are explained in the discussion of the statute, *infra*.

King-Size customarily acquired its inventory from approximately 50 to 100 manufacturers of men's apparel and accessories. Its principal selling vehicles were its fall and spring catalogs, which required extensive preparation. Each of these catalogs had five different editions. For example, the original fall catalog, the October issue, was mailed out in the latter part of September, but variations thereof with different emphasis on the same merchandise were mailed out in the last weeks of October, November, December and January.

The latter two also contained price reductions necessary to sell slower moving seasonal and fashion merchandise.

Because of the special requirements of its customers as to size, weight and durability and because of the long lead time required for catalog sales, King-Size's preparations for each season began many months prior to the publications. It would solicit new resources up to 15 months in advance to ascertain their willingness and capability to manufacture the required merchandise at acceptable prices. In December it would contact acceptable manufacturers for selection of fabrics and styles for the following October catalog. In January it would select the specific items for presentation in the fall catalogs. In January and February it would advise the resources of the models and piece goods selected and the desired specifications. The manufacturers would then make up and submit pilot samples for approval. In February and March King-Size would place orders for all of the fashion items and 75 to 80 percent of the basic items for the fall season. The manufacturers would produce the merchandise from March through September and make deliveries to King-Size's warehouse from August through October and as needed. The end of October represented King-Size's peak inventory accumulation period.

Preparation of the fall catalogs began in February or March upon receipt of the pilot samples and models. The catalogs required illustrations, photographs and artwork, editorial work, composition and other preparations over 5 to 6 months prior to publication.

King-Size uniformly did not pay its suppliers for the inventory on hand on October 31 until November 10. On the other hand, its customers paid cash in advance for their orders.

King-Size's cost for its October 31, 1967 inventory was $1,473,978. Its aggregate retail catalog price for the same merchandise was $3,096,000. In view of the manner in which it accumulated its inventory it is clear that substantially all of it was purchased well after December 20, 1966, when Knapp Bros. acquired the stock of King-Size.

Both parties tried the case on the assumption that the sole issue was the fair market value of the King-Size inventory on

October 31, 1967. However, the statutory scheme and purpose raise a reasonable question as to the correctness of that assumption. Section 334(b)(2) provides that if a corporation purchases 80 percent of the total number of shares of stock of another corporation during a 12-month period and if the purchasing corporation receives the property of the acquired corporation in a complete liquidation pursuant to a plan adopted not more than 2 years after the purchase, then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. The statute further provides that under regulations prescribed by the Secretary of the Treasury or his delegate proper adjustment in the adjusted basis of any stock shall be made for any distribution made to the distributee before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

Section 334(b)(2) was adopted for the first time in the Internal Revenue Code of 1954. SENATE REPORT No. 1622, 83d Congress, 2d Session, page 48 (3 U.S.C. CONG. & ADMIN. NEWS 4679 (1954)) stated the purpose of the section.[1]

> Under the House bill, a shareholder would in all cases be permitted to receive the purchase price for his stock as his basis for the assets distributed to him regardless of the assets' cost to the corporation. In this respect the principle of *Kimbell-Diamond Milling Company* (187 F. 2d 718) was effectuated. Since the application of the rule of this case is primarily in the area of liquidations by a parent corporation of its subsidiary, the rule has been limited by your committee to liquidations of this type. Accordingly, your committee has provided that where a corporation purchases the stock of another corporation and within 2 years after the purchase a plan of liquidation is adopted, the basis of the assets of the subsidiary received by the parent will be the amount paid for the subsidiary's stock.

The bill was amended in conference to provide for limited adjustments to basis for events between the stock acquisition and liquidation dates, the Committee explaining (H. CONF.

[1] HOUSE REPORT NO. 1337, 83d Congress, 2d Session, page 38 (3 U.S.C. CONG. & ADMIN. NEWS 4063 (1954)) stated substantially the same as the first two sentences in the Senate report.

REP. No. 2543, 83d Cong., 2d Sess. 36, U.S.C. CONG. & ADMIN. NEWS 5295 (1954):

> Under section 334(b)(2), which relates to the so-called "Kimbell-Diamond" problem, a parent corporation which liquidates its subsidiary (the stock of which was purchased within the time and in the manner prescribed) receives the assets of the subsidiary at the same basis at which the parent held the subsidiary stock, subject to certain adjustments. Under the Senate amendment, the only adjustment expressly provided for was an adjustment for distributions made to the parent with respect to the stock of the subsidiary before the adoption of the plan of liquidation. Under the amendment recommended in the accompanying conference report, it is provided that, under regulations prescribed by the Secretary or his delegate, proper adjustment will be made not only for such distributions, but also for any money received by the parent corporation, for liabilities, and for other items.

Kimbell-Diamond Milling Co. v. *Commissioner*, 14 T.C. 74 (1950), *aff'd*, 187 F. 2d 718 (5th Cir. 1951), *cert denied*, 342 U.S. 827 (1951), referred to in the committee reports, holds that where one corporation purchases the stock of another with the intent of acquiring the latter's assets by liquidation of the acquired corporation, and in fact liquidates it, the intermediate steps may be disregarded and the entire transaction treated as a purchase of assets at the purchaser's cost of the stock, and such price will be deemed the purchaser's basis of the assets for sale, depreciation and other purposes. Section 334(b)(2) differs in some respect from the *Kimbell-Diamond* rule. It is confined to corporate purchasers, it applies to a purchase of 80 percent of the stock, it does not depend upon the purchaser's subjective intent, it sets limits on the time periods for actions, and it delegates to the Treasury the responsibility for issuing necessary regulations to fill in the details for appropriate adjustments to basis up to the liquidation. *See American Potash & Chem. Corp.* v. *United States*, 185 Ct. Cl. 161, 180–84, 399 F. 2d 194, 206–09 (1968).

Treasury Regulations on Income Tax, section 1.334–1 (c)(4), provides that for purposes of this statute only, the

following adjustments shall be made to the adjusted basis of the subsidiary's stock in the hands of the parent.

1. A reduction for distributions received by the parent from the subsidiary during the period between the purchase of the stock and liquidation, out of other than post-purchase earnings and profits.
2. An increase for the amount of any unsecured liabilities assumed by the parent.
3. An increase for the subsidiary's undistributed earnings and profits between the dates of purchase of the stock and the liquidation.
4. A decrease by the amount of any cash and its equivalent received by the parent.
5. A further decrease by the portion of the subsidiary's deficit in earnings and profits between the purchase and liquidation dates.

With respect to property held on the date of the stock purchase, gain or loss on sales and other items determined by reference to basis, the adjustments are to be computed by substituting for the book basis the parent's adjusted basis for the stock allocable to such property.

Adjustments to the basis of the stock prescribed by section 334(b)(2) are confined by the regulations to distributions of funds or to completed transactions which gave rise to realized increases or decreases in earnings and profits. The apparent rationale is that if a corporation realizes earnings it has additional funds and additional basis for assets in excess of what it had at the time the parent purchased the stock. The converse is true if the subsidiary sells property at a loss.

Leading tax treatises describe the scheme of the regulations as follows:

> [R]egs. 1.334–1(c)(4) attempts to put the parent in essentially the same position, for basis purposes, as if the subsidiary had been liquidated immediately after the parent purchased its stock. [BITTKER AND EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 11.45, at 11–40 (3d ed. 1971).]
>
> The adjustments reflected in the series of complex rules described in this section have as their purpose the objective of producing the same results asset-wise as would have been produced had the parent purchased the assets directly in the first instance. [3A J. MERTENS, JR., LAW OF FEDERAL INCOME TAXATION § 21.168, 482 n. 20.]

> Where there is a delay in liquidating the acquired corporation, Regs. section 334–1(c)(4) require that certain adjustments be made to the basis of the acquired corporation's stock in the hands of the acquiring corporation, prior to allocation of that basis among the assets received upon subsequent liquidation of the acquired corporation. The purpose of the adjustments, in general, is to approximate the result that would have been produced had the acquiring corporation liquidated the acquired corporation immediately. * * * [SURREY, WARREN, MCDANIEL, AULT, FEDERAL INCOME TAXATION 502 (1973).]

The next problem with which the regulation deals is the fair allocation of the aggregate adjusted basis to the various classes of assets the parent receives when it decides to liquidate the acquired subsidiary. Regulations section 1.334–1(c)(4) prescribes the method of allocation as follows:

> (viii) * * * [T]he amount of the adjusted basis of the stock adjusted as provided in this paragraph shall be allocated as basis among the various assets received (except cash and its equivalent) * * *. Ordinarily, such allocation shall be made in proportion to the net fair market values of such assets on the date received * * *.

The quoted portion of the regulations provides that except for cash and its equivalent *ordinarily* allocation of the adjusted basis to the assets shall be made in proportion to the fair market value of such assets on the date received. The use of the term "ordinarily" presupposes that there are some cases where the fair market value is not a proper basis for allocation. Such a case might conceivably be one where the acquiring corporation has its wholly owned subsidiary use cash or credit to purchase other assets after the parent already owns the subsidiary.

If the purpose of section 334(b)(2) and the regulations thereunder is to put the parent in essentially the same position as if it had liquidated the subsidiary the day after it purchased the subsidiary's stock, does the statutory purpose permit the parent to use anything other than the cost of subsequently acquired inventory as its basis for that inventory? Plaintiffs claim here that after the parent had the subsidiary sell off the old inventory it could have it buy new inventory, and the regulation would allow the parent to boost the $1,473,978 cost of the new to a $3,096,000 basis (equiv-

alent to the projected retail selling price) and avoid any income tax on the difference. While it is true that this increased allocation of basis for inventory would cause an off-setting reduction in the basis for goodwill, that would be unlikely ever to be reflected in future taxable income.

The deficiency assessments were apparently made on the assumption that the basis of new inventories purchased after acquisition of the company is cost, since the Commissioner of Internal Revenue determined that Knapp Bros.' basis for the inventory is $1,473,978. The case having been tried and briefed by both parties, however, on the theory that the issue was only one of determining the fair market value of inventory on the date of liquidation, without explanation as to the reason for abandonment of the Commissioner's determination, an inquiry was addressed to them seeking their views as to whether under the statute and regulations the cost of the newly acquired inventory rather than its fair market value should be used in determining the parent's income from the sale of the merchandise after liquidation of the subsidiary. Defendant (as well as plaintiffs) responded that the regulations should be construed to require the use of fair market value for all assets (other than cash) received on liquidation, regardless of when they were purchased.

Defendant's motion for reconsideration of this portion of the original opinion furnishes the rationale which defendant failed to supply earlier. It points out that if on the day after the acquisition of the stock the acquiring corporation had liquidated the acquired corporation and sold the inventory immediately it would have had no taxable income from the sale, since its basis for the inventory, the fair market value, would presumably have been the same as the selling price. However, when an acquiring company does not immediately liquidate the acquired company but allows it to remain in business as a wholly owned subsidiary through the period of an inventory cycle and to sell the original inventory in its own name, they do not enjoy the advantage of the stepped up inventory basis and the subsidiary incurs a liability for income tax on the difference. Therefore, defendant explains, by treating the new inventory as replacement for the old and allowing the taxpayer to substitute a stepped up basis for the

new inventory acquired with the proceeds of the old, the acquiring corporation receives the rough equivalent of the tax benefit it would have had on immediate liquidation of the subsidiary.

This is not a wholly satisfying explanation, since the new inventory for which defendant allows a stepped up basis is not limited by the regulation to that which is in replacement for the old. It may be in addition to the old or many times as large as the old. Indeed it may not have been acquired with the proceeds of sale of any of the old assets but wholly on credit to be paid out of proceeds of sale of the new. However, it cannot be said that the regulation, as interpreted by defendant, is so incompatible with the statutory purpose as to be invalid.

As already noted the statute authorizes the Secretary of the Treasury or his delegate to prescribe regulations with respect to the adjusted basis of the stock and for other items. Such express delegated authority for filling in the gaps in a complicated statute is not merely interpretative. *Cf. Charles Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 65 (1934). It is deemed to give wide discretion to the Secretary in the application of his expert knowledge of the problems the statute was designed to meet. *Bingler* v. *Johnson*, 394 U.S. 741, 749–51 (1969); *United States* v. *Correll*, 389 U.S. 299, 306–07 (1967); *Woolford Realty Co.* v. *Rose*, 286 U.S. 319, 330–31 (1932); *Coca-Cola Bottling Co.* v. *United States*, 203 Ct. Cl. 18, 26, 487 F. 2d 528, 532 (1973). If the Treasury, which has the primary responsibility for protecting the internal revenue, disclaims the benefits of an interpretation of its own regulations favorable to defendant's litigating position, it is questionable whether the court should impose it on defendant, at least for purposes of this case. Accordingly, without deciding that the statute *requires* a regulation having the meaning conceded by defendant, in light of the Treasury's own interpretation of its regulations it is held that plaintiffs are entitled to use as their allocated basis for the King-Size inventory its fair market value as October 31, 1967.

Plaintiffs urge first that the fair market value of the inventory is $3,096,000, its aggregate retail catalog price without

any deductions whatsoever. They urge further, that they are entitled to include as well in their inventory basis goods on order and not yet received, on the theory that this is likewise an asset of the plaintiffs. This would boost the aggregate basis claimed by plaintiffs to a maximum of $4,150,000. The $3,096,000 valuation is not supported by the testimony of any of plaintiffs' expert witnesses. The inclusion of the goods on order is apparently an afterthought because it was never mentioned in the course of the proceedings through trial. Lastly and alternatively, plaintiffs urge a fair market value of $2,678,000 for the inventory on hand on October 31, 1967, which represents $3,096,000 less $417,685, representing the cost of its disposition after October 31. The last is the only valuation supported by the testimony of its expert valuation witnesses, John Eppich, a partner in the accounting firm of Arthur Young and Company, and Frank M. Stotz, a partner in the accounting firm of Price Waterhouse & Company.

As its authority for using the aggregate retail catalog price, the $3,096,000, as the fair market value of the inventory, plaintiffs rely primarily upon a truncated extract from the regulations on estate tax (Treas. Reg. § 20.2031–1(b)). However, the section relied on, set out in the footnote,[2] is not helpful. It deals with the estate tax valuation of a particular item, such as an automobile, owned by a decedent who was a member of the general public, not a dealer, at the time of his death. It concludes that the estate tax valuation of such an item, generally obtained by the public in the retail market, is the retail price. With respect to inventory held by a dece-

[2] "The fair market value of a particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property includible in the decedent's gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example the fair market value of an automobile (an article generally obtained by the public in the retail market) includible in the decedent's gross estate is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the decedent would be purchased by a dealer in used automobiles. * * * The value of items of property which were held by the decedent for sale in the course of a business generally should be reflected in the value of the business. For valuation of interests in businesses, see § 20.2031–3."

dent for sale in the course of business the regulation refers to a different section dealing with valuation of interests in businesses.

As their next authority in support of the claim that the fair market value of its inventory should be the aggregate retail price plaintiffs cite the regulations with respect to deductions from income for charitable contributions of property.[3] However, these regulations are likewise of questionable pertinency. As this court pointed out in *Sheppard* v. *United States*, 176 Ct. Cl. 244, 255, 361 F. 2d 972, 977 (1966), Congress, in an effort to encourage contributions to charities, has approved a policy of permitting donors to deduct gifts of appreciated property without reporting the appreciation as income. Deduction of the value at which a donor customarily sells the item he donates is merely an application of the same congressional policy to property which is a part of the donor's stock-in-trade. *See Campbell* v. *Prothro*, 209 F. 2d 331, 336 (5th Cir. 1954); *Singer Co.* v. *United States*, 196 Ct. Cl. 90, 449 F. 2d 413 (1971); and *Threlfall* v. *United States*, 302 F. Supp. 1114 (W.D. Wis. 1969). No such policy is applicable to an arms-length sale of a business, where the buyer acquires the entire inventory in bulk and both buyer and seller arrive at the aggregate price on the assumption that the buyer will continue to operate the business and sell the stock-in-trade in the usual course of business at a profit.

The more pertinent regulation dealing with the fair market value of inventory is Treasury Regulation 1.471–4, which provides as follows:

> Inventories at cost or market, whichever is lower.

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[3] Treas. Reg. § 1.170–1(c) provides: "*Contribution in property*—(1) *General rules.* If a contribution is made in property other than money, the amount of the deduction is determined by the fair market value of the property at the time of the contribution. The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. If the contribution is made in property of a type which the taxpayer sells in the course of his business, the fair market value is the price which the taxpayer would have received if he had sold the contributed property in the lowest usual market in which he customarily sells, at the time and place of the contribution (and in the case of a contribution of goods in quantity, in the quantity contributed). The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom he customarily sells, unless he sells only at retail in which event it is his retail customers. * * *."

Opinion of Trial Judge

(a) Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular mechandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—

(1) Of goods purchased and on hand,

* * * * *

(b) Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. * * *

The same provisions have appeared in substantially identical form in every regulation on income taxes since article 1584 of regulations 62 under the Revenue Act of 1921 (42 Stat. 227). In *D. Loveman & Son Export Corp.*, 34 T.C. 776, 796 (1960), *aff'd*, 296 F. 2d 732 (6th Cir. 1961), the court held:

> [T]he term "market," in the phrase "lower of cost or market," means the price which petitioners would have had to pay to replace items in their inventories on the applicable inventory dates. Conversely, it does not mean the price at which such merchandise is resold or offered for resale. *Elder Mfg. Co.* v. *United States*, 10 F. Supp. 125 (Ct. Cl.); *Ideal Reversible Hinge Co.*, 7 B.T.A. 1066; see also *Frederick A. Stearns*, 8 B.T.A. 884, 887; *Charles N. Winship*, 10 B.T.A. 237, 240 This point is recognized in the regulations by the specific reference therein to "*bid price* * * * for the particular merchandise in the volume in which usually *purchased* by the taxpayer * * *." (Emphasis [court's].) In short, we are concerned here with petitioners' *replacement* market and not their resale market. * * * [Emphasis court's.]

And *see also Bedford Mills, Inc.* v. *United States*, 77 Ct. Cl. 190, 2 F. Supp. 769, *cert. denied*, 290 U.S. 655 (1933), wherein the court held that the market value of finished goods produced by a manufacturer is the reproductive cost on the inventory date.

These long standing regulations, having survived repeated reenactments of the revenue laws without substantive change, may be deemed to have been approved by Congress and to have the force of law. *Fribourg Nav. Co.* v. *Commissioner*, 383 U.S. 272, 283 (1966); *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938); *Cammarano* v. *United States*, 358 U.S. 498, 510 (1959).

The regulations under section 334(b)(2) do not define fair market value nor do they discuss the nature of the market.[4] Reflection on the purpose of the statute would seem to indicate that Congress intended a definition of fair market value which is neither that applicable to charitable contributions nor that applicable to inventory accounting by an original purchaser or manufacturer of merchandise. It is clear that the scheme and effect of section 334(b)(2) does permit the stockholders of an acquired corporation to obtain at least a degree of inventory profits in the price for which they sell their stock, and accordingly allows the purchaser a stepped-up basis in the same amount. *Jack Daniel Distillery* v. *United States*, note 4 *supra*. But this does not mean that without saying a word to that effect, either Congress or the Treasury in its regulations meant to overturn the long established rule that for tax purposes the market in which a dealer or manufacturer must value his inventory is not his resale market. To allow the purchaser of an entire business to allocate the retail value of the merchandise as its basis for resale in the ordinary course of the continuing operations would be to impute to Congress the intent to require neither the seller of the business nor the purchaser to pay income tax on the ordinary

[4] In *Jack Daniel Distillery* v. *United States*, 180 Ct. Cl. 308, 315, 379 F. 2d 569, 574 (1967), a case involving a determination of the value of inventory under the same statute, the court referred to the standard legal definition of fair market value as "the price at which property would change hands in a transaction between a willing buyer and a willing seller, neither being under compulsion to buy or sell, and both being reasonably well informed as to all relevant facts."

distribution of the inventory—an intent completely foreign to the purpose of section 334(b)(2).

The use of the reproduction cost starting point rather than retail price is also in accord with economic reality. The hypothetical willing buyer of inventory, the principal value of which is the aggregate proceeds he can obtain for it on ultimate distribution, can hardly be expected to ignore what it would cost him to buy the merchandise directly from the manufacturers rather than from the hypothetical seller. Nor is he likely to invest his money absent an opportunity for markups and profits in the range generally earned in such businesses or comparable ones having similar risks. Of course there are always special situations, such as here, where the whole range of sizes, fashions and varieties which make up the inventory and add to its salability cannot be accumulated except over a considerable lapse of time and require expenditures for planning and designing. It is for such reasons that in valuing a bulk inventory acquisition replacement cost should be only a base or starting point. In other words, the hypothetical willing seller here might be expected to demand a price for the inventory which would compensate him not only for the current cost of its replacement but also would give him a fair return on his expenditures over a period of several months in accumulating and preparing the inventory for distribution. Conversely, the purchaser would have to take into account that his purchase price would include the benefit of the seller's prior expertise in planning, designing and getting ready to promote and facilitate the sale of the merchandise at a profit in the near future and would expect to pay for that together with a fair return on it.

It is, however, difficult to apply such rationale to inventory acquired by the subsidiary after the parent already owned all the outstanding stock. The parent, having borne the financial burden of purchasing the inventory in the same way as if it had bought it directly, even if the parent is not limited to its cost basis, no reason is apparent why it should be entitled to use a market value other than replacement, just as any other distributor is required to do. The parent has already received deductions from income for the subsidiary's expenditures in preparation for the sale of the merchandise

(*e.g.*, for planning, advertising, catalog preparation, etc.) in their consolidated return, and to allow it an additional increase in its cost of goods sold for a contribution to value attributable to the same expenses would in effect allow plaintiffs "the practical equivalent of double deduction", contrary to one of the fundamental principles of the tax laws. *Charles Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 68 (1934). And *see also United States* v. *Skelly Oil Co.*, 394 U.S. 678, 684 (1969); *Missouri Pacific R.R.* v. *United States*, 167 Ct. Cl. 725, 729–30, 337 F. 2d 637, 640 (1964); and *Cities Service Oil Co.* v. *United States*, 199 Ct. Cl. 89, 462 F. 2d 1134, 1137–38, *cert. denied*, 409 U.S. 1063 (1972).

For reasons not clear from the record defendant made no effort to value the inventory by any reference to replacement cost. Conceivably this may have been because its sole expert witness foundered and defendant repudiated his testimony, leaving it without any opinion testimony as to value whatsoever.[5] In any event, in its brief defendant has adopted the testimony of plaintiffs' expert witnesses which is based on aggregate retail catalog prices less cost of disposition, but with certain adjustments in the figures and an allowance for a potential profit to the willing buyer. Correctly applied, this valuation method, by working backward, should arrive at close to the same value as by adjusting replacement cost.

Plaintiffs contend that the actual sales to its catalog customers without any deductions whatsoever must be the measure of fair market value of the inventory, because it was the highest and best use and because there was no active market for the sale of such inventory in bulk except at distress prices. However, the argument might be made in substantially every acquisition of an entire business that the highest and best use of the inventory is in sales to the regular retail customers of the acquired company, since the inventory of most distributors is acquired to sell in the market which it customarily serves. If the actual retail prices to be realized in the regular course of business were the only suitable measure of the fair market value of the inventory, the requirement of the regu-

[5] Defendant states in its brief that "The Government has abandoned the opinion of its expert inasmuch as it was not supported by the underlying facts in this case."

lations that the property be valued as of the time of receipt would be an empty gesture, and a company acquiring all of the assets of another would rarely have any taxable income from the sale of the acquired stock-in-trade. It is precisely for these reasons that in the context of such a valuation it becomes necessary to set up a hypothetical willing buyer and willing seller to reconstruct fair value as of the particular date. *Cf. McCormac* v. *United States*, 191 Ct. Cl. 483, 424 F. 2d 607 (1970).

Plaintiffs claim support for their theory in *United States* v. *Cartwright*, 411 U.S. 546 (1973). In *Cartwright*, the Supreme Court held that shares of a mutual fund, which are purchasable only at the approximate fractional value per share of the fund's net assets plus a percentage sales charge going to an underwriter but which are redeemable at the fractional value alone, may properly be valued for estate tax purposes at the redemption price. Plaintiffs argue that this provides a rule of valuation of an asset having a limited market only at the actual sales price.

The analogy is not helpful to plaintiffs. First, *Cartwright* dealt with the estate tax valuation of a unique single non-business asset not included in any regulation; whereas the method of valuation of business inventory in general for purposes of income taxation has long been covered by regulations. Second, the Supreme Court did not say that replacement cost should be disregarded but only the sales or loading charges for the mutual shares which did not go to the seller but were a commission paid to a third person, and, as the Supreme Court noted, are ordinarily excluded from value. Third, the mutual fund shares were redeemable by law on the valuation date at a fixed price determinable on that day; whereas King-Size's inventory was salable only over a period of time in the future, and the actual price could vary with the market and customer acceptance of the style, quality and price of the merchandise. Fourth, the mutual fund shares were in effect subject to a restrictive agreement as to the redemption price voluntarily entered into at the time of purchase, and the opportunity of the owner to sell the shares in private trading was virtually nonexistent; while apparel is salable generally at what it can command on the market,

even though in the quantities of unusual sizes that plaintiff owned it would require extensive efforts to dispose of it all. Fifth, *Cartwright* did not involve a lower replacement cost nor the possibility of income on the sale of inventory in the regular course of business escaping income taxation.

Defendant suggests the approach taken by the Tax Court in *Kraft Foods Co.* v. *Commissioner*, 21 T.C. 513, 585 (1954), *rev'd on another issue*, 232 F. 2d 118 (2d Cir. 1956). There the National Dairy Products Corporation had acquired the business and assets of the Kraft company in a package deal for a lump sum. The court was faced with the problem of determining what part of the consideration properly represented the cost to National Dairy of the Kraft patents and applications for patents. The Commissioner's expert witness valued the patents on the basis of the royalties paid under licensing agreements. The court rejected that manner of valuation because the patents were a part and parcel of the Kraft enterprises, which had the available means and facilities to use them in its business, and it held that it is in that posture that they should be valued. Defendant suggests that in the absence of direct evidence of bulk sales of similar inventory, the inventory in this case must be valued on the theory that it may be sold to a hypothetical willing buyer having facilities equal to that of the seller for distributing it at retail. This constructive approach to fair value is necessarily to be used if the inventory is to be valued as of October 31, 1967.

Such a willing buyer would not be agreeable to paying the full retail price if he knew that he must incur a loss because there had been no allowance for his cost of disposition. Nor would he be willing to pay a price that would merely return his investment without compensating him for the risks which he must incur during the time it took to make the retail sale and for his loss of opportunity to make profits in other ways during the same period on the amount of his investment. Conversely, the willing seller of inventory for a lump sum could hardly expect to receive as much as the aggregate retail price if he was thereby enabled to shift the burden of the disposition costs and risks which would exist during the period of retail sale and if he could invest the proceeds in equally profitable investments or activities elsewhere.

Since both plaintiffs and defendant use the same starting point for valuation, their differences may be readily pinpointed. They both agree that the aggregate retail catalog price is $3,096,000. Plaintiff's valuation witness, Mr. Eppich, conceded that he had made no allowance for returns of defective merchandise. The record reflects customer refunds of approximately 3.9 percent, of which an estimated 20 percent was for defective merchandise. Applying these percentages to $3,096,000 in sales results in a $24,000 allowance for net returns.

Mr. Eppich further conceded that his appraisal failed to take into account the fact that a portion of the inventory was sold after Christmas 1967 at reduced prices. Such sales resulted in Knapp Bros. receiving aproximately $11,000 less than the retail catalog price for the merchandise. Mr. Eppich also admitted that he did not take into account the fact that the catalog allowed small quantity discounts when two or three items were purchased at a time. Mr. Kelly, president of King-Size, estimated that about 30 percent of sales were for other than single items. Examination of the catalog prices shows the discounts were in the neighborhood of 1½ percent. A conservative estimate would place the discounts on the aggregate sales at $5,000.

Defendant also accepts the testimony of plaintiffs' expert witness that there was at least $417,865 in disposition costs for the inventory on hand October 31, 1967. Defendant properly argues, however, that Mr. Eppich failed to take into account several items which boost the disposition costs to $429,216. Mr. Eppich agreed on cross-examination that some sort of computation might appropriately be made for rental of the warehouse in which the inventory was stored and processed for disposition from Novermber 1967 through January 1968. The annual rental paid by King-Size for two buildings in Brockton was $32,000 plus the assumption of $25,000 in operating expenses. Mr. Eppich testified that at least one building was used exclusively for storing and shipping the inventory. In the absence of more specific evidence a fair estimate of the warehouse rental is 50 percent of the net plus 50 percent of operating expenses other than for heat, electricity and security. This approximates $4,000

during the disposition period. For heat, electricity and security at the warehouse a fair estimate based on 50 percent of such aggregate expenses for the period November 1967 through January 1968 is $4,281.

A rented computer was used to keep track of the disposition and of the remainder of the merchandise, to help decide what to feature in the December and January sales catalogs and to assist in deciding to whom and where such catalogs should be sent. The total computer costs are not in the record, but a fair allocation of 50 percent of computer supplies for the same 3-month period is $2,250. The record further supports a $1,000 allocation for November 1967 through January 1968 as the portion of the insurance premiums attributable to the inventory available for sale during that period.

Most important, the parties differ with respect to an allocation of profit to a willing buyer. Neither plaintiffs nor their witnesses make any allowance whatsoever for profit. Defendant properly takes the view that a willing buyer would discount the price he proposed to pay for the bulk purchase so that on the ultimate resale at retail he could make a reasonable profit. Defendant, having no expert witness to support what it deems a fair allocation of such profit, proposes a 50 percent split between buyer and seller. It computes that 50 percent profit as follows: King-Size's average return of profits to sales was 12.2 percent. On net retail sales of $3,056,097 a return of 12.2 percent and an allocation of 50 percent thereof to the buyer results in $186,422 to the buyer.

The weaknesses in defendant's position are several. First, the 12.2 percent is profit before taxes. In computing the amount of discount from the retail selling price at which the hypothetical buyer would bid he would patently use profits after taxes, because that would be his actual net. Second, the average profit on sales for a 4-year period ending in 1967 is not more meaningful than the last year's profit because there is no expert testimony that such period is more representative of what is likely to be than the figures from the most recent year. Third, there is no expert testimony to support any opinion as to the fairness of the 50 percent allocation of profits between buyer and seller. But the vulnerability of defendant's estimate of a fair allocation of profits is matched by a com-

plete lack of evidence on the subject by plaintiffs, which take an all or nothing position. Thus it becomes the burden of the fact finder to reconstruct what is fair from all of the evidence in the record.

For the year ended October 31, 1967, King-Size earned $490,967 in net profits after taxes. The record establishes that although King-Size turned over its inventory the equivalent of three times a year, the net retail value of its October 31, 1967 inventory ($3,056,000) was approximately 38 percent of the fiscal year's net sales ($8,013,621). An investor could therefore reasonably assume that such inventory could be sold so as to yield about 38 percent of $490,967, or $186,567. Although King-Size did not actually pay for the inventory because its successor made the payment on November 10, 1967, undoubtedly King-Size had made itself liable for the $1,473,978 cost when it placed the orders in the prior February and March. King-Size also incurred most of the selling efforts by way of preparation of the October catalog which was the most expensive sales catalog, the others being mere variations thereof with similar artwork. There were risks of possible changes in fashion, changes in price levels, increased competition and possible adverse economic conditions generally, over a period of up to 8 months. On the other hand, the potential buyer had to put out not only the agreed-on price for the inventory but also the disposal costs. He incurred risks similar to those of the seller plus the possible effect of the seller's misjudgment, but for a lesser period of 2 to 3 months, and he lost the interest on his investment.

A fair appraisal of the relative risks, expenses and efforts already incurred by the seller as against those yet to be incurred in order to realize the aggregate retail price, the investment already put in as against those yet to be made to maintain the sales, as well as the relative time spans under which the seller and buyer had to expose themselves to financial risks, are persuasive that the seller would have demanded two-thirds of the net profit to be made while the buyer would have been willing to accept one-third. This results in a profit to the buyer of $62,189 (one-third of $186,567).

In other words, if a willing buyer had put up $2,502,406 plus most of the $429,000 in disposition costs, he would have assumed the likelihood of obtaining $62,189 profits, which results in a 2.1 percent return on his outlay in roughly 3 months, or over an average exposure of 1½ months. On an annual basis this is an equivalent of about a 16.8 percent return on investment after taxes (at the corporate rate).

Plaintiffs' claim that they are entitled in addition to a basis in the goods on order which had not yet been manufactured or delivered as of October 31, 1967, must be rejected out of hand. Even if it might be deemed property for some purposes, there is no substantial evidence in the record as to its value, or that as of October 31, 1967 its value was in excess of plaintiffs' potential liability to pay for it. At that stage any opportunity for increment over potential cost would be a part of the intangible value of the business, which may not be included in the value of other assets for purposes of Regulations section 1.334–1(c)(4)(viii). *See Miami Valley Broadcasting Corp.* v. *United States*, 204 Ct. Cl. 582, 591–92, 499 F. 2d 677, 681–82 (1974).

Both parties purport to find support for their positions in *Jack Daniel Distillery* v. *United States*, 180 Ct. Cl. 308, 379 F. 2d 569 (1967). That case also involved the purchase of a business and the valuation of inventory. However, the acquired company was not merely a distributor but a manufacturer, the inventory at issue was on hand when the parent purchased the stock, it did not consist of products purchased and sold without processing, and the only inventory valuation at issue was the goods in process consisting of whiskey in bulk and in bottling tanks.[6] The court accepted the buying and selling companies' negotiated values based on insurance underwriters' methods of valuation of the whiskey at various stages of aging. They were interpolations between the value of freshly distilled whiskey deemed to be worth only production cost and the case price of the whiskey in glass. Consideration was given to disposal costs, bottling costs, other expenses, interest factors on investment, and the relative

[6] The Government had accepted the taxpayer's valuation of the bottled whiskey ready for sale so the court had no occasion to pass on it. *Jack Daniel Distillery* v. *United States, supra*, 180 Ct. Cl. at 320 n. 9, 338, 348, 379 F. 2d at 577.

Syllabus

profits allocated to the buying and selling companies as a result of the valuations. While the court did not discuss Treasury Regulation section 1.471–4, nor the cases construing it (neither having been brought to its attention by counsel), its ultimate valuation is not inconsistent with the method employed herein. Precise correlation of the application of principles to two such factually complex and different cases cannot be demanded, "especially when it is remembered that determination of fair market value is basically a factual decision, no matter how complicated the reasoning process involved." *Jack Daniel Distillery*, *supra*, 180 Ct. Cl. at 320, 379 F. 2d at 577.

In summary, the fair market value of the King-Size inventory as of October 31, 1967 is $2,502,406.

CONCLUSION OF LAW

Upon the findings of fact and foregoing opinion, which are adopted by the court and made a part of the judgment herein, the court concludes as a matter of law that the court has jurisdiction of these cases and that plaintiffs are entitled to judgments. The amount of their recoveries will be determined in further proceedings pursuant to Rule 131(c).

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526 F. 2d 1131

PETER I. AND ELAINE M. KALLANDER v. THE UNITED STATES

[No. 112–73. Decided December 17, 1975]

ON THE PROOFS

Taxes; income tax; deductions; commuting expenses.—Plaintiff, a commercial airlines pilot, seeks an income tax deduction for the difference in cost respecting 74 trips between his residence and the airport on regular flying assignments during which he used his automobile rather than public transportation, claiming that the use of the automobile was required for transporting back and forth certain job-related equipment, tools and baggage weighing about 50 pounds. It is *held* in view of the evidence that plaintiff would have commuted between residence and airport by private automobile, and not by public transportation, whether or not he was obliged to carry the various items as a condition of employment, and that travel by private automobile was selected because it offered greater comfort, convenience, reliability and flexibility of

meeting mandatory schedules. Accordingly, the carrying of the job-required items in the automobile involved no additional expense to him, and no portion of the commuting cost is deductible. Plaintiff is not entitled to recover and the petition is dismissed.

Taxes; income tax; deductions; trade or business expenses; commuting expenses to and from work.

[1] A commercial airlines pilot who was required on a regular basis and as a condition of employment to carry approximately 50 pounds of equipment, tools and other baggage back and forth between his residence and airport, and who would have commuted by private automobile rather than by public transportation regardless of whether he had to transport said items, is not entitled to deduct any portion of the commuting costs as an ordinary and necessary business expense. The mere availability or adequacy of a less expensive public transportation alternative is insufficient to trigger an allocation of cost. It must be shown that the need to carry necessary tools and equipment was the primary reason for his failure to avail himself of the public transportation and the reason for using private automobile instead.

Internal Revenue ⇐ 566.1

Peter B. Sang, attorney of record, for plaintiffs.

William Kalish, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Theodore D. Peyser* and *Donald H. Olson*, of counsel.

Before LARAMORE, *Senior Judge*, KASHIWA and BENNETT, *Judges*.

PER CURIAM: This case comes before the court on plaintiff's exceptions to the recommended decision filed by Trial Judge Louis Spector on March 19, 1975, pursuant to Rule 134(h), having been submitted to the court on the briefs without oral argument of counsel. Upon consideration thereof, since the court agrees with the trial judge's recommended decision, as hereinafter set forth, it hereby affirms and adopts the same as the basis for its judgment in this case. It is therefore concluded as a matter of law that plaintiff is not entitled to recover and the petition is dismissed.

OPINION OF TRIAL JUDGE

SPECTOR, *Trial Judge:* This is one of those tax cases which involves a small sum of money but a large issue. It is an issue

which has heretofore been considered by several circuits of the U.S. Court of Appeals [1] and by the Supreme Court.[2] Those decisions provide the necessary guidelines for disposition of this case, on its particular facts.

Plaintiff,[3] during the tax year in question (1968), was a commercial airlines pilot employed by Northeast Airlines,[4] a trunk carrier then 11th in size in the United States. Its route structure extended from Montreal, Canada, to Miami, Florida, and to intermediate points. Plaintiff resided in Southborough, Massachusetts, where he had grown up, and he was based at Logan International Airport, Boston, Massachusetts, about 30 miles from his residence.

This case involves the deductibility [5] for income tax purposes of the additional cost (by private automobile over public transportation) of commuting between residence and airport. Defendant has disallowed the deduction of any part of plaintiff's commuting costs on the grounds that they are "personal, living, or family expenses." [6]

As a condition of his employment, plaintiff was required to use and maintain certain manuals, tools and other equipment. Some were required while piloting the aircraft, and depended upon the type of aircraft being flown, and upon whether plaintiff was serving as captain, copilot or flight engineer.[7] It was a further condition of his employment that plaintiff study and update his various manuals and related equipment to maintain his personal qualifications and proficiencies. In addition, plaintiff was subject to spot tests by his employer and by the FAA at irregular intervals to insure that he was maintaining the requisite flight skills under normal and abnormal conditions.

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[1] *Coker* v. *Commissioner*, 487 F. 2d 593 (2d Cir. 1973); *Fausner* v. *Commissioner*, 472 F. 2d 561 (5th Cir. 1973); *Tyne* v. *Commissioner*, 385 F. 2d 40 (7th Cir. 1967); and *Sullivan* v. *Commissioner*, 368 F. 2d 1007 (2d Cir. 1966).

[2] *Fausner* v. *Commissioner*, 413 U.S. 838 (1973). *See also*, case note on *Fausner*, 26 BAYLOR L. REV. 262.

[3] Referring to Peter I. Kallander. Elaine M. Kallander is a party solely because she filed a joint income tax return with her husband.

[4] Since merged into Delta Airlines.

[5] As a trade or business expense under Int. Rev. Code of 1954, § 162 (26 U.S.C. § 162).

[6] 26 U.S.C. § 262 (Int. Rev. Code of 1954).

[7] In 1968, plaintiff flew four different types of aircraft, and in various positions on each aircraft.

Because plaintiff's employer did not maintain storage or study facilities at Logan adequate for updating flight manuals, plaintiff kept his manuals and other equipment in an office area maintained in his home, where they were readily accessible for study and assembly for a particular flight. These items, therefore, had to be carried back and forth between residence and Logan in a flight bag weighing 26 pounds.

In addition, plaintiff was required to carry certain street clothing and other personal effects for use while not in flight, because use of his airline uniform while off duty was restricted. The amount and type of such clothing varied with the geographical destination of the flight, and the length of the layover at destination. The average weight of that suitcase was 24 pounds. In summary, plaintiff was regularly required to carry a total of about 50 pounds of equipment and clothing between home and airport.

To some extent plaintiff determined his working hours and his flight assignments under a procedure whereby pilots "bid" for available flight schedules based on personal preference coupled with seniority. Plaintiff testified that during 1968 his bids were predicated on varying factors, but were primarily motivated by an interest in higher earnings, a desire to fly the most sophisticated aircraft (which is closely related to higher earnings), and an occasional need to secure certain days or weekends off as requested by his wife.

Plaintiff was required, subject to disciplinary action, to report 1 hour prior to departure for necessary preflight check-in. He could be asked to report for special flying assignments, called "reserve" assignments, on as little as 3 hours' notice, thus allowing him as little as 2 hours to prepare and commute to the airport. In many instances, he received much longer notice (up to 24 hours) of reserve flying assignments.

In the tax year 1968, plaintiff made a total of 82 trips between residence and Logan, 74 of them on regular flying assignments requiring transportation of the earlier described flight equipment and personal items. He seeks an income tax deduction as to those 74 trips, for the difference in cost be-

tween commuting by private automobile [8] and by public transportation [9] on the grounds that the use of private automobile was required by the need to carry that equipment and baggage.

On the eight remaining trips to Logan in 1968, for flight training purposes not requiring the transport of equipment and baggage, plaintiff also used his private automobile, and he could recall no trip by public transportation during 1968. He explains this by noting that his commuting pattern had been established by the need to use his car when burdened with equipment on the far more numerous flying assignment trips to the airport.

The available public transportation consisted of the following. In 1968, there was a local bus stop about 500 feet from plaintiff's residence. That bus system provided service on a regular basis to a shopping center in Framingham, Massachusetts, about 7 miles away. The service originating near his residence was on a regular basis at intervals ranging from every 15 minutes to every hour, depending on the time of day. Plaintiff's wife could have driven him to Framingham, if necessary, to catch the next bus, which went from Framingham to the airport, or to downtown Boston, sometimes as an express and sometimes not, all depending on the schedule.

These large buses from Framingham to Boston had the typical storage bins underneath for baggage, so that a bus operator stopping for a passenger carrying baggage, would have to disembark and use special handles to open the storage bins and load or unload a passenger's bags. Plaintiff was concerned that a driver might not always stop for a baggage-laden passenger, especially in inclement weather.

From downtown Boston it was a 10-minute walk to the Park Square subway terminal, and a 5-minute subway ride to the Government Center terminal. From there it was a subway ride to the airport, followed by a shuttle bus ride to the Northeast Airlines terminal. About 25 percent of Northeast's flights departed before 9 a.m.

It was plaintiff's testimony that the travel time from his home to the Northeast terminal at Logan by the above-described public transportation system would be approxi-

[8] At 10 cents per mile, $3 each way, plus tolls.
[9] $1.82 each way.

mately 1 hour and 10 minutes during nonrush hour periods. He similarly estimated that the normal driving time by private automobile, during corresponding periods, would be from 45 minutes to 1 hour and 10 minutes, depending upon traffic congestion on the expressways and in the tunnels leading to Logan airport. The last portion of the trip, from downtown Boston to the airport, was said to be faster by subway than by automobile.

When plaintiff arrived at the airport in his private automobile, he parked in an area reserved for airline employees about three-fourths of a mile from the terminal area, and took a shuttle bus to the terminal. This shuttle bus also operated on a regular schedule but, unlike the one available to those using public transportation, it had been specially adapted for flight personnel and their baggage, by removal of seats in the front of the bus.

Plaintiff testified that he declined to use the public transportation system above-described for any of his 74 regular flying assignments because it was impractical to carry his heavy equipment, tools and other baggage to the bus stop, and on and off the buses and subway trains, and to stow them in a separate luggage compartment on the large intercity bus. He states that he otherwise *could* have used public transportation on many flight assignments, and that he *could* have bid for monthly flight schedules so as to permit the use of such public transportation; but he did not testify that he *would* have done so, absent the baggage problem.

As the cases show, this is a key issue because we must search out the "but for" cause which triggered the use of a private automobile in this case. On that point plaintiff testified with commendable candor that if he had not been required to carry equipment, tools and baggage he "could only speculate that I would take it [public transportation] sometimes; as to how many times, or what percentage, I—it would be speculative, and I don't know how much value it would be to you; I could say a third of the time perhaps—I don't know. I wouldn't have any business at the airport if I didn't have my tools and instruments; they wouldn't let me on the airplane."

It is equally speculative whether the availability of public transportation would have been a significant factor motivat-

ing plaintiff's bids for flight assignments, had he not been burdened with equipment, tools and other baggage. Under the circumstances which actually existed, we know that he was motivated principally by the prospect of higher earnings and the opportunity to fly more sophisticated aircraft. Ordinarily these would be more important factors than the availability of public transportation.

Plaintiff owned two automobiles during 1968, a period when he and his wife were the only licensed drivers in his household. Here again one can only speculate whether the second car was maintained because of plaintiff's special commuting problems, or for personal convenience.

In summary, plaintiff has had the burden of describing an available public transportation system, so difficult and inconvenient as to render it impractical for a commuter laden with the above-described equipment and baggage; but at the same time so convenient and practical that it would be the preferred mode of travel by a commuter not so laden. That is a difficult burden, and it has not been met.

The conclusion can fairly be drawn from the record that plaintiff would have commuted between residence and airport by private automobile, and not by public transportation, whether or not he was obliged to carry approximately 50 pounds of equipment, tools and other baggage as a condition of employment. It is concluded that travel by private automobile was selected because it offered greater comfort, convenience, reliability and flexibility in meeting mandatory schedules.

Once it is concluded that plaintiff would have employed his private vehicle to commute in any event, the carrying of his job-required equipment, tools and baggage in the car involved no additional expense to him, and it is not deductible. That is the teaching of the Supreme Court's opinion in *Fausner*,[10] particularly when read in the light of the decisions which preceded and followed it.

The taxpayer in *Fausner* was also a commercial airlines pilot, who regularly commuted by private automobile. He sought to deduct the entire cost of commuting, not just an allocable portion, as in this case. The Tax Court and later

[10] Note 2 *supra*.

the Court of Appeals disallowed the deduction *in toto*. The record indicated "that Fausner would have driven to work even if it had not been necessary to carry the bags, *since no convenient public transportation was available.*" [11] (Emphasis supplied.)

Fausner (originating in the Fifth Circuit), specifically declined to follow the rule announced in *Sullivan* (Second Circuit), and *Tyne* (Seventh Circuit),[12] to the effect that some allocable portion of the expenses incurred should be allowed as a deduction.

As stated in *Fausner:*

> * * * This is not a situation where a proper allocation can be made by any analytical determination of actual cost of the deductible component. * * *
>
> * * * * *
>
> The short answer is that since he introduced no evidence that he incurred any expense *in excess of nondeductible commuting expense* in transporting his two bags, Fausner failed to carry the burden of establishing his right to the deduction claimed. * * *
>
> * * * * *
>
> * * * Since the record shows that Fausner *would have driven his car to and from his place of employment anyway*, we cannot find that he is entitled to what would amount to special relief which would distinguish him from other taxpayers because of the mere fortuity that he placed the bags he was required to carry in the trunk of his commuting vehicle. Congress has determined that all taxpayers shall bear the expense of commuting to and from work without receiving a deduction for that expense. This common burden cannot be negated for a particular taxpayer by the happenstance that he must carry incidentals of his occupation with him. [Emphasis supplied.] [13]

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[11] Note 1 *supra*, 472 F. 2d at 562.

[13] Note 1 *supra*.

[12] 472 F. 2d at 562–63. In *Sullivan*, note 1 *supra*, the taxpayer lived on Staten Island and worked for a construction contractor at various sites in Manhattan, Brooklyn and Staten Island. He carried a 32-pound bag of tools which he had to take back and forth each day. He also had a bad knee which rendered difficult the walking and standing required by public transportation. The Commissioner had conceded that a taxpayer may deduct reasonable driving expenses *"if* he can show that he would *not* have driven his automobile to work if it had not been necessary to take his tool bag." [Emphasis supplied.] 368 F. 2d at 1008. But the court in *Sullivan*, confronted with the

In affirming the Fifth Circuit in *Fausner*, the Supreme Court noted at the outset "that petitioner would have commuted by private automobile regardless of whether he had to transport his two bags." [14] It concluded:

> * * * We cannot read § 262 of the Internal Revenue Code as excluding such expense from "personal" expenses because by happenstance the taxpayer must carry incidentals of his occupation with him. Additional expenses may at times be incurred for transporting job-required tools and material to and from work. Then an allocation of costs between "personal" and "business" expenses may be feasible. But no such allocation can be made here. [Footnotes omitted.] [15]

It is clear that the intent of the Court is that "no such allocation can be made" when, as here (and as in *Fausner*), the taxpayer "would have commuted by private automobile regardless of whether he had to transport his two bags." The Second Circuit has since modified its rule in the *Sullivan* case to conform with *Fausner*.[16]

In summary, the mere availability or adequacy of a less expensive public transportation alternative, is insufficient to trigger an allocation.[17] It must be shown that the need to carry necessary tools and equipment was the primary reason for the taxpayer's failure to avail himself of that public transportation, and the reason for his using private automobile instead. The tools and equipment are not the "but for" reason for using private automobile when the taxpayer would have commuted by that method in any event.

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classic case of a heavily laden Manhattan commuter, concluded further:

"* * * Even if taxpayer *would have driven* to and from work had it *not* been necessary to transport his tools, he ought to be allowed to deduct *that portion* of his reasonable driving expenses which is allocable to the transportation of tools.

* * * * *

"* * * For example, where a journey is made *primarily* for business but partly for personal reasons, its expenses may be allocated between the two purposes." [Emphasis supplied.] 368 F. 2d at 1008–09.

Tyne (note 1 *supra*) was in accord with *Sullivan*.

[14] 413 U.S. 838.

[15] 413 U.S. at 839.

[16] *Coker*, note 1 *supra*.

"* * * *Fausner* clearly overrules *Sullivan*, and holds that none of the commuting costs are deductible when, as in this case, the taxpayer would have used his automobile in any event. * * *" 487 F. 2d at 594.

[17] *See & cf. Tyne*, 385 F. 2d at 42–43.

It follows that plaintiff is not entitled to recover, and his petition is dismissed.

FINDINGS OF FACT

1. Plaintiff Peter I. Kallander is a commercial airline pilot. He was employed during 1968 (the tax year in issue) by Northeast Airlines which has since merged into Delta Airlines. Elaine M. Kallander is a party to this action solely because she filed a joint income tax return with her husband. Hereinafter the term plaintiff or taxpayer refers to Peter I. Kallander.

2. During the year in issue plaintiff resided at 14 Meadow Lane, Southborough, Massachusetts, which had been his home for about 25 years. Plaintiff grew up in Southborough and chose to live on the same street where his parents resided. His place of residence was not a condition of employment.

3. In 1968 Northeast Airlines was a trunk carrier, 11th in size in the United States, operating from Montreal, Canada, to Miami, Florida, and points in between. Plaintiff was based at Logan International Airport, Boston, Massachusetts, about 30 miles from his residence. All of his flight assignments in 1968 originated and terminated at Logan.

4. As an express condition of his employment, plaintiff was required to use and maintain certain manuals, tools and other equipment. Some were required while piloting the aircraft, depending upon the type of aircraft being flown; and whether plaintiff was flying as captain, copilot or flight engineer. In 1968 plaintiff flew four different types of aircraft in various positions. Each had its own separate set of instruction manuals, which further varied with the position of pilot, or copilot.

5. As a condition of his employment, plaintiff was required to study and update his various manuals and related equipment to maintain his personal qualifications and proficiencies. Plaintiff also had to be prepared for tests by his employer and the Federal Aviation Agency at irregular intervals to insure that he was maintaining the requisite flight skills under normal and abnormal conditions.

Findings of Fact

6. Plaintiff's employer does not maintain storage facilities at Logan, nor adequate study facilities for updating flight manuals. Plaintiff kept his manuals and other equipment in an office area maintained in his home where they were readily accessible for study and assembly for a particular flight. The required items, therefore, had to be carried back and forth between residence and Logan in a flight bag weighing 26 pounds.

7. Plaintiff was required to wear an airline uniform while on duty, but its use was restricted while plaintiff was off duty. Hence plaintiff was also required to carry certain street clothing and other personal effects for use while not in flight. The amount and type of such clothing varied dependent upon the geographical destination of the flight and the length of the layover period prior to return to Logan. The average weight of the suitcase in which plaintiff carried his personal clothing was 24 pounds, so that plaintiff regularly carried a total of about 50 pounds of clothing and equipment between home and airport.

8. Plaintiff determined his working hours and flight assignments to some extent by "bidding" for available flight schedules. The bidding procedure was based on relative seniority and personal preferences. During 1968 plaintiff predicated his bids on a number of factors which varied from month to month. The evidence shows that the factors which motivated him were (1) higher earnings; (2) a desire to fly the most sophisticated aircraft, which was also related to higher earnings; and (3) an occasional desire to bid for certain days or weekends off, as requested by his wife.

9. In the tax year 1968 plaintiff made a total of 82 trips between residence and Logan. Of these, 74 were related to regular flying assignments for which he was required to carry the above-described flight equipment and personnel items. As to these 74 trips, he seeks a tax deduction for the difference in cost between commuting by means of his private automobile and the corresponding cost of public transportation. He asserts that private automobile was required by reason of the described flight equipment and baggage.

10. There were approximately eight other trips to Logan for flight training which did not involve transport of the above-described baggage. Those eight remaining trips in 1968 were also made by private automobile. Plaintiff had no recollection of a trip by public transportation during 1968, stating that his commuting pattern had been established by the need to travel by private automobile, when burdened with the above-described equipment.

11. In 1968 there was a public bus stop about 500 feet from plaintiff's residence. It provided service on a regular basis at intervals ranging from every 15 minutes to every hour, depending on the time of day. That bus proceeded to a shopping center in Framingham, Massachusetts, about 7 miles away. Plaintiff's wife could have driven him to Framingham, if necessary. From there plaintiff could have taken an express bus, if available, during some hours of the day direct to the airport. At other hours of the day that bus went to downtown Boston. These large buses from Framingham to Boston had storage bins underneath for baggage. When stopping for a passenger carrying baggage, the bus operator would have to disembark and use special handles to open the storage bins and load or unload a passenger's bags. Plaintiff was concerned that a driver might not always stop for such a passenger, especially in inclement weather. From downtown Boston it was a 10-minute walk to Park Square subway terminal, and a 5-minute subway ride to the Government Center terminal. From there, it was a subway ride to the airport, followed by a shuttle bus ride to the Northeast terminal. About 25 percent of Northeast's flights departed before 9 a.m.

12. Plaintiff estimated that travel time from his home to the terminal at Logan, by the above-described public transportation system, would be approximately 1 hour and 10 minutes during nonrush hour periods. He estimated normal driving time, by private automobile during corresponding periods, to be approximately 45 minutes to 1 hour and 10 minutes. It depended on traffic congestion on the expressways and in the tunnels leading to the airport. From downtown

Boston to the airport the subway was faster than an automobile.

13. Upon arrival at the airport in his private automobile, plaintiff parked in an area reserved for airline employees, about three-fourths of a mile from the terminal area. It was served by a shuttle bus operating on a regular schedule, and specially adapted for flight personnel and their baggage. Seats had been removed in the front of the bus to accommodate pilots' and other crew members' flight bags. The earlier mentioned public shuttle bus lacked this feature.

14. Under union contract, plaintiff was entitled to 3 hours' notice when asked to report to Logan for special, *i.e.*, "reserve" flying assignments. He was required (subject to disciplinary action) to report 1 hour prior to departure for preflight check-in, thus allowing him 2 hours to prepare and commute to the airport. In many instances, much longer notice (up to 24 hours) was provided for reserve flying assignments.

15. In 1968 plaintiff declined to use public transportation from residence to airport and return for any of his 74 regular flying assignments. He felt it was impractical to carry his equipment, tools and other required baggage to the bus stop, and on and off the buses and subway trains, and to stow them in a separate luggage compartment on the large bus. He states that he could have used public transportation on many flight assignments, and that he could have bid for monthly flight schedules so as to permit the use of such public transportation. But he testified that if he had not been required to carry equipment, tools and baggage, he "could only speculate that I would take it [public transportation] sometimes; as to how many times, or what percentage, I—it would be speculative, and I don't know how much value it would be to you; I could say a third of the time perhaps—I don't know. I wouldn't have any business at the airport if I didn't have my tools and instruments; they wouldn't let me on the airplane."

16. Plaintiff could have bid flight schedules so as to permit maximum use of public transportation, but he did not consider the possible use of public transportation in bidding for

monthly flight assignments. He was motivated by the prospect of higher earnings and the opportunity to fly more sophisticated aircraft. There is no evidence that the factor of public transportation would have entered into plaintiff's bidding considerations, had he not been burdened with equipment, tools and other baggage.

17. Plaintiff owned two automobiles in 1968, and his household had only two licensed drivers during that year.

18. In 1968 the cost of public transportation from plaintiff's residence to the airport was $1.82 each way. The cost of driving a private automobile at 10 cents per mile was $3 (plus tolls) each way.

ULTIMATE FINDINGS OF FACT

19. Plaintiff was required on a regular basis, and as a condition of employment, to carry approximately 50 pounds of equipment, tools and other baggage between residence and airport, and return.

20. On the evidence of record, plaintiff would have commuted between residence and airport by private automobile, and not by public transportation, whether or not he was obliged to carry approximately 50 pounds of equipment, tools and other baggage as a condition of employment. Travel by private automobile was selected because it offered greater comfort, convenience, reliability and flexibility in meeting mandatory schedules.

21. Since plaintiff would have employed his private automobile to commute between residence and airport in any event, the carrying of the above-described equipment, tools and baggage in the automobile involved no additional expense to him.

CONCLUSION OF LAW

Upon the foregoing findings of fact and opinion, which are adopted by the court and made a part of the judgment herein, the court concludes as a matter of law that plaintiff is not entitled to recover, and plaintiff's petition is dismissed.

Syllabus

530 F. 2d 864

MOTORS INSURANCE CORPORATION v. THE UNITED STATES

No. 132–73

MOTORS INSURANCE CORPORATION, SUCCESSOR IN INTEREST TO GENERAL EXCHANGE INSURANCE CORPORATION v. THE UNITED STATES

No. 133–73

[Decided January 28, 1976]

OPINION

Taxes; income tax; deductions; net operating loss carryback; foreign tax credit; limitation on credit; geographical allocation of deduction.—Plaintiff (and its predecessor in interest) is a stock casualty insurance company operating, during the relevant periods, solely in the United States and Canada. Plaintiff seeks refunds of income taxes assessed and paid for its taxable year 1959 (Case 132–73) and for its predecessor's taxable year 1955 (Case 133–73) resulting from net operating loss carryback adjustments in said years in which foreign tax credits were claimed and allowed. These cases are before the court on a stipulation of facts, the controversy involving the necessity for recomputation of the prior years' limitation on allowable foreign tax credit, and, if recomputation is required, whether the net operating loss carryback deductions should be allocated directly to income from specific geographical sources or should be apportioned ratably between gross income from foreign sources and gross income from sources within the United States. It is *held* that the foreign tax credit limitation must be recomputed to reflect the impact upon taxable income of a net operating loss carryback deduction, and, where possible, as upon the stipulation before the court, such loss deduction should be allocated in specific part directly to income according to its geographical source. These rules are in accord with the policies underlying the net operating loss carryback and foreign tax credit provisions of the 1954 Internal Revenue Code. Taxable income as defined by the Code more accurately reflects the relative success or failure of the business over the business cycle. The credit is allowed, but in any event never to exceed the amount of United States income tax which would be due, absent the credit, in respect of taxable income from each geographical source. The petitions are dismissed.

Syllabus

Taxes; income tax; deductions; net operating loss carryback; generally.

[1] The net operating loss provisions contained in Sec. 172 of the 1954 Internal Revenue Code, allow a taxpayer, within stated limits, to recognize as a deduction against gross income in a profitable year a portion of losses actually realized in another, to the end of "averaging out" taxable income over a span of years more closely resembling a true business cycle.

Internal Revenue ⟸ 669

Taxes; income tax; credits against tax; foreign tax credit; limitation on credit.

[2] The purpose of the foreign tax credit rules contained in Secs. 901, *et seq.* of the 1954 Internal Revenue Code are calculated to relieve a taxpayer, within stated limits, of harsh consequences attendant upon double taxation of the same elements of its taxable income. However, Sec. 904 imposes a limitation upon the foreign tax credit in order to prevent the tax credit from reducing or eliminating the United States tax on income from sources within the United States.

Internal Revenue ⟸ 701

Taxes; income tax; credits against tax; foreign tax credit; limitation on credit; net operating loss carryback.

[3] The holding in *Lewyt Corp.* v. *Commissioner*, 349 U.S. 237 (1955), that in computing taxpayer's carryback deductions for a prior taxable year, the excess profits tax payment must be computed on the income accrued within the taxable year, and that events transpiring after the close of the taxable year were not to be taken into account, is interpreted by this court to mean: except those events required by statute or valid regulation to be taken into account. Thus, although the accrual method of accounting may in some instances render irrelevant events in later years, nothing in *Lewyt* purports to hold that Congress may not otherwise provide, as in the case of Secs. 841, 832, 172 and 904 of the 1954 Internal Revenue Code respecting limitation on foreign tax credit in computing a stock casualty insurance company's loss carryback deduction for a prior taxable year. The court prefers a dutiful application of the statutes themselves.

Internal Revenue ⟸ 669, 701

Taxes; income tax; deductions; net operating loss carryback; generally.

[4] For many purposes the net operating loss carryback is equivalent to a *de novo* determination of the tax of a prior taxable year.

Internal Revenue ⟸ 669

Taxes; income tax; deductions; net operating loss carryback; foreign tax credit; recomputation of foreign tax credit limitation.

[5] Where a stock casualty insurance company seeks, under the

Opinion of the Court

provisions of Sec. 172 of the 1954 Internal Revenue Code, a net operating loss carryback adjustment for a prior taxable year in which it claimed and was allowed a foreign tax credit, the prior year's foreign tax credit limitation imposed by Sec. 904 of the Code must be recomputed to reflect the impact of the loss deduction, but such credit must never exceed the amount of United States income tax which would be due, absent the credit. This conclusion comports with the policies underlying the taxing provisions of Secs. 841, 832, 172 and 904 of the Code, a reduced limitation on foreign tax credit more accurately reflecting average taxable income over the business cycle.

Internal Revenue ⇐ 669, 702

Taxes; income tax; deductions; net operating loss carryback; foreign tax credit limitation; geographical allocation of deduction.

[6] Having decided that a previously reported foreign tax credit limitation must be recomputed to take account of a net operating loss carryback deduction, upon the stipulated facts Sec. 862(b) of the 1954 Internal Revenue Code requires, for purposes of computing the correct value of the recomputed foreign tax credit limitation, that the new operating loss carryback deduction be allocated directly to income generated in the prior carryback year from the same geographical source which later engendered the loss. The fact that the income against which the loss is deducted was generated in another taxable year is of no consequence, since the purpose of the carryback provision is to do away with the rigors of the normal 1-year accounting span.

Internal Revenue ⇐ 669, 701

E. Alan Moorhouse, attorney of record, for plaintiff, *Frazer F. Hilder* and *Paul H. Zalecki*, of counsel.

Bruce W. Reynolds, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Theodore D. Peyser* and *John E. Evans*, of counsel.

Before DURFEE, *Senior Judge*, SKELTON and BENNETT, *Judges*.

BENNETT, *Judge*, delivered the opinion of the court:

This income tax refund litigation comes before us upon a stipulation of facts pursuant to Rule 134(b) of the Rules of this court. Because of similarity of issues, the cases are consolidated for decision. We are invited in each case to decide issues involving the foreign tax credit, which the parties represent to be questions of first impression. First,

where a corporate taxpayer seeks a net operating loss carryback adjustment for a prior taxable year in which it claimed and was allowed a foreign tax credit, we are asked whether the prior year's foreign tax credit limitation imposed by section 904, Internal Revenue Code of 1954, must be recomputed so as to reflect the impact of the net operating loss deduction.[1] A second question must be faced only if the first is answered in the affirmative: if a net operating loss carryback deduction does require recomputation of the prior year's limitation on allowable foreign tax credit, in assigning the correct value to the new limitation fraction, we must inquire whether such net operating loss carryback deduction should be allocated directly to income from specific geographical sources, or on the other hand, should be apportioned ratably between gross income from foreign sources and gross income from sources within the United States.[2]

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[1] At the time in question sections 841 and 901 of the Internal Revenue Code of 1954 allowed taxpayers to credit against United States tax liability certain amounts of taxes paid or accrued to foreign countries. Section 841 merely incorporates section 901 by reference, permitting application of section 901 *et seq.* in the case of certain domestic insurance companies. Section 901 then provided, in pertinent part:

"§ 901. TAXES OF FOREIGN COUNTRIES AND OF POSSESSIONS OF UNITED STATES.

"(a) *Allowance of credit.*—If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) * * *.

"(b) *Amount allowed.*—Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

"(1) *Citizens and domestic corporations.*—In the case * * * of a domestic corporation, the amount of any income * * * taxes paid or accrued during the taxable year to any foreign country * * *."

Section 904, however, imposed an upper limit upon the available credit:

"§ 904. LIMITATION ON CREDIT.

"(a) *Limitation.*—The amount of the credit in respect of the tax paid or accrued to any country shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources within such country (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year."

[2] Treas. Reg. § 1.901–2(d) (1959) provided, while in force:

"§ 1.901–2 *Definitions.*

* * * * *

"(d) That principles of sections 861 through 864 and the regulations thereunder shall apply in determining the sources of income for the purposes of sections 901–905, inclusive."

Int. Rev. Code of 1954, § 862(b), provides:

"(b) *Taxable income from sources without United States.*—From the items of gross income specified in subsection (a) there shall be deducted the * * * losses * * * properly apportioned or allocated thereto, and a ratable part of any * * * losses * * * which cannot definitely be allocated to some item or class of gross income. * * *."

Motors Insurance Corporation (MIC) is a stock casualty insurance corporation duly organized and existing under the laws of the State of New York, with its principal place of business in New York City. At all relevant times MIC had operations solely in the United States and Canada. Case No. 132–73 involves a claim for refund of income taxes assessed and paid for MIC's taxable year 1959. For that year the taxpayer first reported taxable income from all sources of $3,571,592.67, and taxable income from Canadian sources of $882,633.99. Before application of the foreign tax credit, MIC's United States income tax amounted to some $1,851,728.19.

Section 904 of the Code imposes an upper limit upon the amount of available credit, which conveniently may be expressed in terms of the following formula: [3]

$$\text{Maximum allowable foreign tax credit} = \text{United States income tax liability before application of foreign tax credit} \times \frac{\text{Taxable income from the relevant foreign country}}{\text{Taxable income from all sources}}$$

Substituting the figures applicable to this case, in its original return for taxable year 1959 the taxpayer computed its section 904(a) limitation on foreign tax credit to be $457,610.50, as follows:

$$\text{Maximum allowable foreign tax credit } (\$457{,}610.50) = \$1{,}851{,}728.19 \times \frac{\$\ 882{,}633.99}{\$3{,}571{,}592.67}$$

Inasmuch as MIC encountered creditable tax liability to Canada in that year only to the extent of $307,876.56, a credit was noted on the return for the entire amount of such Canadian tax properly accrued.

For its taxable year 1962 MIC experienced a net operating loss, and by reason thereof on August 26, 1963, filed an Application for Tentative Carryback Adjustment (form 1139) for its taxable year 1959. In short, MIC took advantage of the privilege conferred by section 172 of the Code to reopen its taxable year 1959 and to report as an additional deduc-

[3] This formula appears upon inspection of section 904, note 1, *supra*. We have some experience in its application. *Missouri Pac. R.R.* v. *United States*, 183 Ct. Cl. 168, 392 F. 2d 592 (1968).

tion from that year's gross income a portion of its 1962 net operating loss.[4] By check dated November 15, 1963, MIC received a refund of the entire $1,543,851.63 claimed in the application, together with statutory interest amounting to $80,745.55.

Thereafter the Internal Revenue Service conducted a timely audit of MIC's taxable year 1959. The service determined that the taxpayer owed the Treasury an additional $279,466.58 in respect of that year as well as statutory interest of $50,642.42, principally on account of two adjustments. First, the amount of the net operating loss carryback deduction was reduced from $3,142,883.07 to $2,555,816.69. In this much of defendant's action plaintiff finds no error. Second, the service recomputed MIC's 1959 limitation on foreign tax credit. A specific portion of the 1959 net operating loss deduction attributable to 1962 losses was directly allocated to 1959 taxable income from Canadian sources. Thus, taxable income from Canada—the numerator of the section 904 limitation fraction—was reduced by $408,842.11 from the original $882,633.99, to a new figure of $473,791.88. The denominator of the fraction—taxable income from all sources—diminished to the extent of the entire net operating loss carryback deduction. This figure became $1,016,875.54. On account of the carryback deduction MIC's United States recomputed income tax prior to application of the foreign tax credit totalled $523,275.28. Thus, the service calculated the new credit limitation to be $243,808.70, as follows:

Recomputed foreign tax credit limitation ($243,808.70)	=	$523, 275. 28 ×	$ 473, 791. 88
			$1, 016, 875. 54

[4] Section 172, Int. Rev. Code of 1954, provides, in part:

"§ 172. NET OPERATING LOSS DEDUCTION.

"(a) *Deduction allowed.*—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. * * *.

"(b) *Net operating loss carrybacks and carryovers.*—

* * * * *

"(2) *Amount of carrybacks and carryovers.*— * * * [T]he entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the 'loss year') shall be carried to the earliest of the 7 taxable years to which * * * such loss may be carried. The portion of such loss which shall be carried to each of the other 6 taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. * * *."

The $243,808.70 limitation so ascertained resulted in partial disallowance of the $307,876.56 foreign tax credit originally reported for taxable year 1959.

The taxpayer instituted this timely action upon payment of the disputed assessment and administrative denial of its refund claim. Plaintiff invokes our jurisdiction under 28 U.S.C. § 1491 (1970).

In the companion case, No. 133–73, MIC sues as successor in interest to General Exchange Insurance Corporation (GEIC), which predecessor merged into MIC on May 31, 1960. Like MIC, GEIC confined its business enterprise to the United States and Canada. At all relevant times GEIC also was a stock casualty insurance corporation duly organized under the laws of New York. This controversy involves a claim for refund of income taxes assessed and paid for GEIC's taxable year 1955. For that year this taxpayer reported in an amended return taxable income from all sources of $13,402,922.05, and taxable income from Canadian sources of $1,094,586.89. Before application of the foreign tax credit, GEIC's United States income tax, as originally reported, amounted to $6,961,704.82.

In its tax return for taxable year 1955 the taxpayer computed its section 904(a) limitation on foreign tax credit to be $568,546.98, as follows:

Maximum allowable foreign tax credit ($568,546.98)	=	$6,961,704.82 (United States income tax before foreign tax credit)	×	$1,094,586.89 (taxable income from Canadian sources)
				$13,402,922.05 (taxable income from all sources)

Inasmuch as GEIC encountered creditable tax liability to Canada in that year only to the extent of $353,535.11, a credit was noted on the return for the entire amount of such Canadian taxes properly accrued.

For its taxable year 1957 GEIC experienced a section 172 net operating loss,[5] and by reason thereof on June 16, 1958, filed an Application for Tentative Carryback Adjustment (form 1139) for its taxable 1955. By check dated October 7,

[5] *See* note 4, *supra*.

1958, GEIC received a tax refund of $796,221.08, together with statutory interest of $36,746.14.

The Internal Revenue Service responded by conducting a timely audit of GEIC's taxable year 1955. The service determined that MIC, as GEIC's successor, owed the Treasury an additional $155,617.45 in respect of that year as well as statutory interest of $94,293.61, principally on account of two adjustments. First, the amount of the net operating loss carryback deduction was reduced from $1,531,194.38 previously asserted to $1,520,253.57. The parties do not dispute this action. Second, the service recomputed GEIC's 1955 limitation on foreign tax credit. A specific portion of the 1955 net operating loss deduction attributable to 1957 losses was directly allocated to 1955 taxable income from Canadian sources. Thus, taxable income from Canada—once again, the credit limitation numerator—was reduced by $1,417,033.66 from an adjusted figure of $1,065,801.52, or, to zero.[6] As a necessary consequence the totality of GEIC's initially reported foreign tax credit for 1955 was disallowed and a deduction of $353,811.22 substituted therefor.

MIC instituted this timely action upon payment of the disputed assessment and administrative denial of its claim for refund. Once again, plaintiff invokes our jurisdiction under 28 U.S.C. § 1491 (1970).

In both cases, Nos. 132–73 and 133–73, MIC stipulates that it does not dispute the amount of the allocation of net operating loss made to Canadian branch operations of MIC and GEIC in their respective loss years. However, plaintiff stops short of conceding the legal correctness of the allocation so made for purposes of computing the prior years' section 904 limitations—upon MIC's foreign tax credit for 1959, and GEIC's credit for 1955.

I.

In resolving the first issue—whether a net operating loss carryback deduction requires recomputation of a prior, profit-

[6] It will be recalled that GEIC originally reported as taxable income from Canadian sources $1,094,586.89, which amount figured in the initial computation of the section 904 limitation. The stipulation bears out the inference that during the course of auditing GEIC's taxable year 1955, the service lowered this figure for other reasons to $1,065,801.52 before allocating thereto any portion of the 1955 net operating loss deduction attributable to 1957 losses.

able year's foreign tax credit limitation—we start by observing the judicially recognized policies which undergird these important taxing provisions. These purposes will guide us in the solution of these difficult cases, and must be kept in mind throughout.

The Supreme Court at an early date articulated the legislative purpose in adopting the net operating loss carryover and carryback provisions:

> * * * Those provisions were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year [footnote omitted]. * * *. [*Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382, 386 (1957).]

Thus, in limited circumstances a taxpayer will be allowed under section 172 of the 1954 Code to recognize as a deduction against gross income in a profitable year a portion of losses actually realized in another, to the end of "averaging out" taxable income over a span of years more closely resembling a true business cycle.

The purpose of the foreign tax credit rules, section 901 *et seq.*, we perceive to be similarly ameliorative. These provisions are calculated to relieve the taxpayer, within stated limits, of harsh consequences attendant upon double taxation of the same elements of its taxable income. *American Chicle Co.* v. *United States*, 316 U.S. 450, 451 (1942). But Congress has seen fit in section 904 to impose a limitation upon the foreign tax credit. The legislature has stated, in effect, that the amount credited against United States income tax liability shall not exceed the United States income tax which otherwise would be due on account of foreign-source taxable income, in the absence of the credit. Alternatively stated, as we said in *Missouri Pac. R.R.* v. *United States*, 183 Ct. Cl. 168, 181, 392 F. 2d 592, 601 (1968), the foreign tax credit limitation "is designed to prevent the tax credit from reducing or eliminating the United States tax on income from sources within the United States."

Bearing in mind these purposes we turn to the first of the problems at hand. Must a section 904 limitation on foreign

tax credit be recomputed where, due to net operating loss in a subsequent year, the prior year's return is reopened and the taxable income reported thereon adjusted by application of the additional deduction embodied in section 172(a)(2)? Of logical necessity it must, and we so hold.

The correctness of this view emerges upon examination of the applicable taxing statutes. At all operative times section 841(2) of the Code provided, in pertinent part:

> § 841. CREDIT FOR FOREIGN TAXES.
>
> The taxes imposed by foreign countries * * * shall be allowed as a credit against the tax of a domestic insurance company subject to the tax imposed by section * * * 831, to the extent provided in the case of a domestic corporation in section 901 (relating to foreign tax credit). *For purposes of the preceding sentence, the term "taxable income" as used in section 904 means—*
>
> * * * * *
>
> (2) in the case of the tax imposed by section 831, *the taxable income (as defined in section 832(a)).*[7] [Emphasis supplied.]

Section 832 in part provided:

> (a) *Definition of taxable income.*—In the case of an insurance company subject to the tax imposed by section 831, *the term "taxable income" means the gross income as defined in subsection (b)(1) less the deductions allowed by subsection (c).*
>
> * * * * *
>
> (c) *Deductions allowed.*—In computing the taxable income of an insurance company subject to the tax imposed by section 831, *there shall be allowed as deductions:*
>
> * * * * *
>
> (10) *deductions * * * as provided in* part VI of subchapter B (*sec. 161 and following, relating to itemized deductions for individuals and corporations*); * * *. [Emphasis supplied.]

[7] Section 831(a)(1) of the Code imposed taxes as computed in section 11 upon the taxable income of every insurance company other than life insurance companies or mutual insurance companies. The stipulation recites that plaintiff and its predecessor were at the relevant times "stock casualty insurance companies." Therefore, section 831 applies in these cases.

Section 172, which allows a deduction for certain net operating loss carrybacks, has always been situated in part VI of subchapter B, Internal Revenue Code of 1954. To us the conclusion seems legally irresistible that in computing taxable income for purposes of the numerator and the denominator of the section 904 limitation fraction, a section 172 net operating loss deduction attributable to a business reverse in a later year must, under section 832(c)(10), be treated like any other deduction from the prior year's gross income. Where taxable income under section 172 is reduced in general to the extent of the additional deduction, we think the Code provisions above show beyond doubt that such taxable income must be reduced in particular for purposes of the foreign tax credit limitation set down in section 904. We should not be inclined to depart from this reasoning in the absence of manifestly controlling authority requiring a contrary result.

Plaintiff resists this characterization of its case first by citing *Lewyt Corp.* v. *Commissioner*, 349 U.S. 237 (1955). The taxpayer deduces from this case the asserted principle that the net operating loss carryback deduction is unique among taxing provisions and, as such, applies to the earlier, profitable carryback year only for the limited purpose of allowing an additional deduction from that year's gross income. In short, plaintiff contends that the loss carryback has no bearing whatever on the prior year's foreign tax credit limitation.

In *Lewyt* the taxpayer experienced profitable years in 1944 and 1945, but realized net operating losses both in 1946 and 1947. It sought to deduct the net operating loss attributable to 1946 against its previously reported income both for 1944 and 1945. The Commissioner disapproved a deduction for 1945 on the ground that 1944 income was more than sufficient to absorb the entirety of allowable 1946 loss, and that under section 122(b)(1) of the 1939 Code, a deduction could be permitted against income in the year (1945) next preceding the loss year (1946) only if income realized in the second preceding taxable year (1944) was entirely abated by the

later year's (1946) net operating loss.[8] In his determination that 1944 net income was large enough to accommodate the entire 1946 loss, the Commissioner developed the position that the 1946 net operating loss required (1) recomputation and downward adjustment of an excess profits tax due and owing for 1944—which would result in *diminution* of the income tax deduction originally taken on account of such excess profits tax liability, and (2) a corresponding *upward* adjustment of 1944 net income. Such enhanced 1944 net income was large enough to absorb the totality of the 1946 loss. Thus the Court was called upon to decide "whether the excess profits tax that may be offset [as a deduction under section 122(d)(6)] against 1944 net income is the amount of excess profits tax reported for the year in question [under the taxpayer's accrual accounting method] or the amount ultimately found to be due" as recomputed in light of the net operating loss carryback. 349 U.S. at 238.

In holding for the taxpayer, the Court did conclude that the net operating loss deduction did not require recomputation of a prior year's income tax deduction for an excess profits tax liability, where such deduction had been properly accrued in the prior year. *Id.* at 242–43.

> In short, the amount of tax accrued within the taxable year under § 122(d)(6) is to be determined in accord with the normal accounting concepts relevant to the accrual basis. That amount is not, of course, to be ascertained solely by reference to the figure set forth in the taxpayer's return, for that figure may be erroneously computed on the accrual basis. But when an amount is arrived at by proper application of recognized accounting principles on the accrual basis, the test of § 122(d)(6) has been met. Events and transactions of later years, irrelevant to a determination of income on the accrual basis, do not warrant alteration of the figure computed under § 122(d)(6) for the year in question.

[8] Section 122(b)(1) of the 1939 Code, as amended, provided:

"If for any taxable year * * * the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d)(1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss." [26 U.S.C. § 122(b)(1) (1946).]

We think that Mr. Justice Douglas turned the decision in *Lewyt* principally on a proper reading of section 122(d)(6) of the 1939 Code, which provided for a deduction against gross income for " 'the amount of tax *imposed by* Subchapter E of Chapter 2 [*i.e.*, the excess profits tax] paid or *accrued* within the taxable year * * *.' " 349 U.S. at 238–39. (Italics by Court.) But we do not think that *Lewyt* may properly be understood to hold that a net operating loss *never* affects the taxable income of a prior year, in the face of specific taxing statutes in the 1954 Code which lead so forcefully to a contrary result in the case of a foreign tax credit limitation. In view of the technical wording of the 1939 Code so heavily relied upon in the Supreme Court's opinion, and because of the 5–3 split in the *Lewyt* Court,[9] we decline the invitation to extend its rationale to the cases before us. Although the accrual method of accounting may in some instances render irrelevant events in later years, nothing in *Lewyt* purports to hold that Congress may not otherwise provide, as in the case of sections 841, 832, 172, and 904, previously discussed.

This court's opinion in *National Forge & Ordnance Co.* v. *United States*, 139 Ct. Cl. 204, 151 F. Supp. 937 (1957), confirms *Lewyt's* inapplicability here:

> The *Lewyt* case says it must be computed on the income accrued within the taxable year. * * * [T]he court said with equal clarity that events transpiring after the close of the taxable year were not to be taken into account. However, we must conclude that this means, "*except those required by statute or valid regulation to be taken into account.*" * * *.
>
> We hold, therefore, that in computing the excess-profits tax to be deducted from 1944 income, in order to determine the amount of the net loss for 1946 to be applied against it, we must compute it on its income accrued within the year, as extended by section 3806 and I.T. 3611.
>
> After the deduction of these excess profits taxes, the net operating loss is to be applied against the remainder. If it exceeds the remainder, the excess is to be applied against 1945 net income.

[9] Mr. Justice Frankfurter's *Lewyt* dissent was cited with approval by the majority in the later case, *Libson Shops, Inc.* v. *Koehler*, *supra*, 353 U.S. at 386 n. 5.

> We think this is in accord with the holding of * * * *Lewyt Corp.*, * * * *supra.* [Emphasis supplied. 139 Ct. Cl. at 208, 151 F. Supp. at 939.]

Other cases giving *Lewyt* a narrow reading include *Budd Co.* v. *United States*, 252 F. 2d 456, 458 (3d Cir. 1957), and *Commissioner* v. *Pacific Affiliate, Inc.*, 224 F. 2d 578, 580 (9th Cir. 1955).

Plaintiff next seeks comfort in *Memphis Transit Co.* v. *United States*, 155 Ct. Cl. 797, 297 F. 2d 542 (1961), *cert. denied*, 371 U.S. 815 (1962), wherein taxpayer sued for refund of income and excess profits taxes. After generating profits in 1943 and 1944, the plaintiff encountered losses in 1945, 1946, and 1947 due to abandonment of its investment in an electric street railway system. For these loss years, the taxpayer sought carryback adjustment relating to 1943 and 1944.

In its bid for refund of excess profits tax the taxpayer theorized in part as follows: (1) The net operating loss carryback deductions decreased the amount of income and excess profits taxes due for its prior, profitable years. (2) Such decreased tax liability resulted in a corresponding increase in the taxpayer's accumulated earnings and profits accounts for taxable years 1944 and 1945. (3) Such increase in turn enlarged available excess profits credits for those years, and so decreased the adjusted excess profits net income subject to tax. 155 Ct. Cl. at 802–03, 297 F. 2d at 545–46. The opinion indicates that the court relied primarily on the logic of Rev. Rul. 55–28, 1955–1 CUM. BULL. 359, in rejecting this line of reasoning. The court did say, however, that it thought the argument to be at odds with the *Lewyt* decision.

Our decision today is entirely consistent with *Memphis Transit*, *supra*, although that case had nothing to do with the foreign tax credit. There, much like the Supreme Court in *Lewyt*, this court principally concerned itself with proper application of accrual accounting techniques in the absence of specific statutory provision mandating an exception to the general rule—as in the case of sections 841, 832, 172, and 904 when read as an integrated whole. We do not think this decision lends any particular support to taxpayer here, in view of our earlier decision in *National Forge & Ordnance*

Co., *supra*. We prefer a dutiful application of the statues themselves.

Plaintiff looks also to *Manning* v. *Seeley Tube & Box Co.*, 338 U.S. 561 (1950). There in a profitable year the taxpayer encountered income tax liability which was tardily paid, together with assessed statutory interest. Subsequently, the company was adjudged bankrupt and, owing to a net operating loss in the year of its demise, carried back an appropriate deduction to the prior year. The deduction was sufficient to abate the entire tax liability for such prior year, but upon application for refund the Service declined to return the statutory interest which had been assessed and paid due to the taxpayer's lateness in filing. The Supreme Court approved the Government's action. It was thought that although the carryback did ultimately abate the erstwhile tax liability, at all times prior to the loss year the Treasury had had the right to possess the money while the taxpayer had retained its use. 338 U.S. at 565–66. The Court declined to construe the net operating loss carryback provisions in a manner which would approve a taxpayer's failure to pay its tax on time. *Id.* at 567. We see no conflict between this decision and our conclusion in these cases. *Manning* relates to the duty to pay tax punctually, and to the Government's correlative right to possess the funds so paid. These matters have little if any bearing on the question we now face: the effect of a net operating loss carryback deduction upon a carryback year's foreign tax credit limitation. If anything, *Manning* supports our view:

> * * * it is true that for many purposes the carry-back is equivalent to a *de novo* determination of the tax, * * *. [338 U.S. at 567.]

We are not impressed by plaintiff's reliance on the *Manning* decision.

As stated, we think our decision to be required by application of the statutory provisions hereinbefore mentioned. Moreover, persuasive authority supports this approach. Rev. Rul. 71–432, 1971–2 CUM. BULL. 270 is directly in point, except that it states the case of a domestic corporation deriving its entire income from sources in two foreign countries. The service there holds that a net operating loss carryback does

require recomputation of a previously reported limitation on foreign tax credit. The Commissioner adheres to a like position in the case of a net operating loss carryover from a loss year to a later year. Rev. Rul. 69–121, 1969–1 CUM. BULL. 194. Additionally, defendant refers us to Treas. Reg. § 1.172–5 (a) (3) (ii) (1975) which states:

> Unless otherwise specifically provided in this subchapter, any deduction which is limited in amount to a percentage of the taxpayers' taxable income * * * shall be recomputed upon the basis of the taxable income * * * determined with the modifications prescribed in this paragraph * * *.

This regulation goes on to explicate adjustments required by a net operating loss carryback, in respect of the prior year's deductions which are subject to limitations expressed as a percentage of taxable or adjusted gross income. Had the Service included in this language a reference to *credits* limited by reference to a percentage of taxable income, we might assume that these cases would not presently be before us. Nonetheless, in the absence of a showing that section 1.172–5 (a) (3) (ii) clearly contradicts the statute it purports to interpret, we are required to consider it a correct construction of the law—at least so far as it goes. *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948). Here we think it to be presumptively correct and highly persuasive authority for the defendant's position, with which we thoroughly agree.

As a final persuasive authority one should consult E. OWENS, FOREIGN TAX CREDIT 254–57 (1961), wherein the author discusses the issue which now confronts this court. Her treatment of the topic indicates that a net operating loss carryback deduction does indeed mandate recomputation of both numerator and denominator in the prior year's foreign tax credit limitation fraction.[10]

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[10] *See generally* Gifford, *United States Tax Effects of Foreign Losses: A Symmetry Analysis*, 83 YALE L. J. 312, 339–40 (1973). The author examines what he believes to be inconsistent treatment of foreign losses by the Code, and makes suggestions for change: "If a current loss has an effect on the foreign tax credit computations for years other than the loss year * * * then the effect will not be symmetrical since gain will affect the computation only for the current year."

Our conclusion that a net operating loss carryback deduction impels revision of the carryback year's foreign tax credit limitation coexists comfortably with the aforementioned policies underlying these taxing provisions. A reduced limitation on foreign tax credit more accurately reflects average taxable income over the business cycle. *Libson Shops, Inc.* v. *Koehler*, *supra*. In like manner, a reduced limitation assures the Treasury that the credit will not deprive it of taxes due on account of taxable income, as recomputed, from sources within the United States. *Missouri Pac. R.R.* v. *United States*, *supra*. Leaving the credit untouched by a carryback deduction in effect would provide a dollar-for-dollar abatement of a portion of income taxes attributable to United States taxable income, as recomputed. We could not sanction such a result.

II.

Having decided that a previously reported foreign tax credit limitation must be adjusted to take account of a net operating loss carryback deduction, in recomputing such limitation it remains to inquire whether the deduction is susceptible of direct allocation to income from specific, geographical sources in the prior carryback year. The taxpayer would have us reply in the negative, apportioning its loss ratably between Canadian and United States income.

Section 862(b), Internal Revenue Code of 1954, provides:

> (b) *Taxable income from sources without United States.*—
>
> From the items of gross income specified in subsection (a) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as taxable income from sources without the United States.

Treas. Reg. § 1.901–2(d) (1959) establishes the applicability of section 862(b) of the Code in these cases for purposes of ascertaining the numerator of the credit limitation fraction:

> (d) The principles of sections 861 through 864 and the regulations thereunder shall apply in determining

the sources of income for the purposes of sections 901–905, inclusive.

The taxpayer contends that a net operating loss carryback deduction, relating as it does to operations in a subsequent loss year, cannot properly be allocated directly to specific geographical income sources for *any* prior year. Rather, these deductions must be apportioned ratably between Canadian and American sources by reference to gross income from those countries as set forth in Treas. Reg. §§ 1.862–1(b), 1.861–8(a) (1959). Although the parties have been less than graphic in apprising us of the precise computational consequence of this argument, we think it safe to assume that if we approve the taxpayer's position the numerator of the limitation fraction will be larger than it would be were we to accept the view urged upon us by the Government.

Defendant, for its part, raises as a threshold question the problem of whether section 862(b) of the Code could have applied at all in the case of a stock casualty insurance company during the years in question. Assuming that it did apply, the Government argues that on this stipulation the Code requires direct allocation of net operating loss carryback deductions to Canadian-source income for purposes of recomputing the credit. We may assume that if the Government is correct on either point, the numerator of the foreign tax credit limitation fraction will decrease.

As we understand it, the Government's threshold position derives from the wording of section 842 (since deleted) during the operative time:

> The *gross income* of insurance companies subject to the tax imposed by section * * * 831 shall not be determined in the manner provided in part I of subchapter N (relating to determination of sources of income) [section 861 and following]. [Emphasis supplied.]

It is said that if section 861 and following had no bearing upon computation of an insurance company's *gross* income, then likewise those provisions may not apply in determining the taxable income of such a business entity. In this phase of the case the Government seems not to take into account the contrary indication in Treas. Reg. § 1.901–2(d), *supra*, and such authority as exists seems to favor the plaintiff, if only

to this extent. In *Northwestern Mut. Fire Ass'n* v. *Commissioner*, 181 F. 2d 133 (9th Cir. 1950), the court appears to have disapproved an argument similar to that now pressed by defendant:

> Taxes imposed upon petitioner * * * [a mutual insurance company] were based not upon its normal-tax net income ["taxable income" under the 1954 Code], but solely upon the alternative basis—"gross amount of income" as defined in Int. Rev. Code [of 1939], § 207 (a) (2). In view of that fact limitation of foreign-tax credits by a ratio of normal-tax net income appears to have no logical basis. But as legislative history reveals, mutual insurance companies such as petitioner present unusual problems of tax administration. Resolution of those problems has been made, if impirically, by the Congress. Our function is at an end when we have determined the scope of congressional action. [Citation omitted.]
>
> The foreign taxes paid by petitioner * * * do not exceed the limitation specified in * * * § 131(b) [§ 904 of the 1954 Code]. The claims for refund are therefore allowable. [181 F. 2d at 136.] [11]

For purposes of these cases, however, we think it entirely unnecessary to decide whether the Government is correct in its assertion that the Code's source of income rules have no application in the case of a stock casualty insurance company. Even if we assume that section 862(b) does apply in these cases, as the taxpayer contends, the Government must prevail. Upon the stipulation before us we think that these net operating loss deductions can and must be allocated directly to income generated in the prior carryback years from the same geographical sources. The case law dealing with proper allocation of *current* losses to current sources of income commends this conclusion to us.

In *Torrington Co.* v. *United States*, 137 Ct. Cl. 622, 149 F. Supp. 172 (1957), plaintiff in 1942 realized a war loss incident to seizure by the Nazi government of its German subsidiary's operating assets. For the same taxable year the parent company claimed a foreign tax credit, but calculated its limitation on such credit in a manner unacceptable to the

[11] For a discussion of this case, see E. OWENS, FOREIGN TAX CREDIT 210–12 (1961).

Treasury. In setting up the limitation fraction, the taxpayer reduced the denominator—normal tax net earnings (now taxable income) from all sources—by the amount of the war loss. It did not reduce the numerator, however—normal tax net earnings from sources without the United States. The taxpayer there took the position that a "war loss" was not a "loss" at all within the meaning of section 119(d) of the 1939 Code, presently codified in section 862(b). In framing the question for decision, the court provides some guidance on the slightly different question at issue here:

> It is apparent from a reading of this subsection that if we hold a § 127 war loss is a loss within the meaning of § 119(d) it must be deducted from gross income from sources without the United States in order to arrive at the correct net income from such sources [which would be the numerator in the limitation fraction]. * * *. [137 Ct. Cl. at 625, 149 F. Supp. at 174.]

Thus, the court assumed the allocation of a loss to a specific, geographical source of income (the situs of the loss assets) to be required by the predecessor of section 862(b) of the Internal Revenue Code of 1954.

Other courts have approached more closely the issue now at hand. Thus, in *De Nederlandsche Bank*, 35 B.T.A. 53 (1936), the then Board of Tax Appeals undertook to consider proper allocation of a current operating loss to the appropriate income source. The taxpayer, a foreign corporation having United States business operations, deducted from its gross income realized within the United States a ratable portion of certain losses on loans made in Europe. Naturally, the service took a contrary position—that the losses were wholly attributable to income from without the United States under section 217(e) of the Revenue Act of 1926, and as such nondeductible against United States-source income. It is true that this case did not involve a foreign tax credit. Yet it is entirely apposite since allocation of operating losses to sources of income there was required for purposes of computing what the 1954 Code defines as taxable income. As we have seen, taxable income constitutes the point of departure in computing a foreign tax credit limitation.

In holding against the taxpayer the court said:

* * * The losses are * * * clearly identified with specific accounts of banks located in Holland. Moreover, the proceeds of these loans were further advanced by the bank to other concerns doing business in Holland.

* * * [T]he simple fact seems to be that, whatever the motive that impelled the loans, they were losses suffered on specific accounts in Holland and should be allocated to income earned in Holland.

The corollary of this line of thought is to consider the "Reorganization Loans" from their relation to the earning of income within the United States. The applicable statute (§ 234(b)) allows deductions "only if and to the extent that they are connected with income" within the United States. The remainder of the statute allowing a ratable part of items which can not definitely be allocated does not purport to be based on any other premise. The concept underlying this provision is that some part of such items is related to the earning of income within the United States. This relationship to the income within the United States must be apparent, although the determination of the amount may be left to more or less arbitrary allocation. * * *.[12] [35 B.T.A. at 59–60.]

In this case the Board of Tax Appeals approved direct allocation of current operating losses to income from a specific geographical source, because the losses related to the earning of income from such foreign sources.

Similarly, in *Royal Ins. Co.*, 38 B.T.A. 955 (1938), the board approved a resident foreign corporation's allocation of a current loss to income from United States sources, where the asset involved (common stock) had a United States situs:

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[12] The operative statutes involved in *De Nederlandsche Bank*, 35 B.T.A. 53 (1936), sections 234(b) and 217(e) of the Revenue Act of 1926, provided in part:

"(b) In the case of a foreign corporation * * * the deductions allowed in subdivision (a) shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions * * * shall be determined as provided in section 217 * * *."

Section 217(e):

"(e) * * *. In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the expenses, losses or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which can not definitely be allocated to some items or class of gross income; * * *." Practically the same language now appears in section 862(b).

> Obviously, this investment did not produce income outside the United States. *A fortiori*, the loss sustained was not connected with income from outside the United States. * * *.
>
> The investment, from which the loss occurred, was made for the purpose of deriving income from United States sources. * * *. [38 B.T.A. at 957.]

Once again the situs of the asset generating the loss controlled, requiring direct allocation of such losses to income from that same situs. *Stockholms Enskilda Bank*, 40 B.T.A. 107 (1939), followed the geographical situs rule of *Royal Ins. Co.*, on facts exhibiting an even more tenuous connection between the capital asset and its physical location—the United States.

Commissioner v. *Ferro-Enamel Corp.*, 134 F. 2d 564 (6th Cir. 1943), presents a case requiring allocation of a current loss to income from foreign or domestic sources under section 119(d) of the Internal Revenue Code of 1939 (now section 862(b)), for purposes of computing the limitation on foreign tax credit. A domestic taxpayer purchased stock in one of its suppliers, a Canadian corporation, to the end of assuring itself a constant source of raw material. Ultimately the stock became worthless, and for the year in which the loss was recognized for tax purposes the question arose as to whether it should be allocated to income from United States or Canadian sources under the predecessor of section 862(b). Understandably, the taxpayer allocated it to net income from United States sources—a component of the limitation fraction denominator, while the Commissioner attributed it entirely to income from sources without the United States—diminishing the numerator. 134 F. 2d at 565. In reversing the Board of Tax Appeals the court had this to say regarding sections 119(b) and (d):

> The statute in question undertakes to classify the sources of income within * * * and without the United States by the nature and location of the activities of the taxpayer or his property which produces the income. If the income be from service, the place where the service is performed is decisive. If the income is from capital, the place where the capital is employed is controlling. If the income arises from the sale of a capital asset or a loss from its disposition, the place where the sale occurs, or the loss happens, is decisive.

> In the case at bar, the loss by reason of the purchase of the * * * stock occurred when the corporation ceased existence and discontinued its mining operations. The evidence clearly shows that respondent invested in the stock * * * for the sole purpose of obtaining raw material * * *, and that it in no sense intended to make an investment with the expectation of receiving dividends on the stock. As we view the statute, this fact does not convert the loss into a deduction from respondent's income from sources within the United States. The loss grows out of an activity or use of property and the situs of the loss is not transferred to the home of respondent because respondent wished to obtain a source of raw material.
>
> The case should be viewed and decided in the same light as if respondent had purchased a cobalt mine in Canada and had sustained a loss in its operation. Under these circumstances, it would clearly be a loss sustained from sources without the United States. [134 F. 2d at 566.]

In summary, *Ferro-Enamel* and the other authorities disclose the rule that where a loss is realized in the endeavor to generate income from specific geographical sources, in applying section 862(b) of the Code such losses may properly be applied in reduction of income from such geographical sources. E. OWENS, FOREIGN TAX CREDIT 247 (1961).

Turning to the case at bar, the stipulation recites:

> For purposes of this suit, plaintiff does not dispute the amount of allocation * * * of the MIC [or GEIC] net operating loss for 1962 [or 1957, respectively] made to Canadian Branch operations by the Internal Revenue Service, but MIC does not stipulate that the Internal Revenue Service was legally correct in the allocation which it made of [those] * * * carryback(s) to "taxable income from Canadian sources" for purposes of computing the Section 904(a) limitation upon MIC's [or GEIC's] foreign tax credit for 1959 [or 1955, respectively].

We find in this language a fundamental concession that specific portions of net operating losses were realized in the endeavor to generate income from Canadian branch operations during the loss years. We see no reason why such losses should not therefore be attributed in specific part directly to income in the carryback years derived from the same

sources. The situs of the assets giving rise to the loss ordinarily controls, as here. *Commissioner* v. *Ferro-Enamel Corp., supra; Torrington Co.* v. *United States, supra; Stockholms Enskilda Bank, supra; Royal Ins. Co., supra; De Nederlandsche Bank, supra.* The fact that the income against which the loss is deducted was generated in another taxable year is of no consequence. As we have observed, the purpose of the carryback provision is to do away with the rigors of the normal 1-year accounting span. *Libson Shops, Inc.* v. *Koehler, supra.* Section 862(b) and the cases convince us that direct allocation of these carryback deductions more accurately depicts income over the longer period from Canadian and American sources, respectively. We conclude that the net operating loss carryback deductions before us were properly allocated directly to the prior carryback year's income from the geographical sources which later engendered these losses.

Cases cited by plaintiff respecting allocation of current expenses to sources of current income for purposes of the foreign tax credit limitation do not lead to a contrary result. In *Missouri Pac. R.R.* v. *United States*, 183 Ct. Cl. 168, 392 F. 2d 592 (1968), after establishing the creditability of a tax paid to Mexico, the court decided that in determining the correct numerator of the limitation fraction certain items of current expense were not directly allocable to income from Mexican sources. Rather, interest paid on purchase-money indebtedness for acquisition of coaches, property taxes applicable to such property, and other expenses were to be allocated ratably between United States and Mexican income. 183 Ct. Cl. at 185, 392 F. 2d at 603. Taxpayer reads *Missouri Pac.* to stand for the proposition that a deduction cannot be allocated directly to an item or class of gross income under section 862(b) unless it was incurred in the same taxable year as the year in which such income was earned. Using the court's words:

> * * * [W]e are concerned only with the following two classes of deductible expenses: (1) Those which are directly assignable to Mexico because they are directly attributable to and incurred in earning the rental income in Mexico; and (2) the Mexican portion of expenses which are not directly assignable to the income from

> either country and must, therefore, be allocated ratably between the two countries. [183 Ct. Cl. at 183, 392 F. 2d at 602.]

The taxpayer reasons that a net operating loss deduction must be apportioned ratably in this case between Canadian and American income, since 1 year's loss cannot possibly be considered as "incurred" in earning the income of another year.

Plaintiff misapprehends the thrust of *Missouri Pac.* The cited passage merely characterizes the factual nature of the current expenses there involved, and does not state an iron-clad rule of law dispositive in the case of a net operating loss carryback. Actually, we restated the general rule under section 119(d) of the 1939 Code (now section 862(b)) in the paragraph preceding that now relied upon by the plaintiff:

> * * * [I]f an expense or other deduction, or some part thereof, can be definitely assigned to gross income earned in either the United States or Mexico, then it should be so assigned and no proration is necessary * * *. Those deductions which cannot reasonably be directly assigned to one country or the other should be allocated ratably between the two. * * *. [183 Ct. Cl. at 183, 392 F. 2d at 602.]

As stated, we conclude in this case that the net operating loss carryback deductions are assignable in specific part *directly* to gross income earned in Canada, albeit income of a prior taxable year. Accordingly, we think that we have observed scrupulously the law as it is set down in *Missouri Pac.*, and restated in *Chicago, Milwaukee R.R.* v. *United States*, 186 Ct. Cl. 250, 404 F. 2d 960 (1968).

III.

In summary and conclusion, in our view a foreign tax credit limitation must be recomputed to reflect the impact upon taxable income of a net operating loss carryback deduction. Where possible, as upon the stipulation before us, such loss deduction should be allocated in specific part directly to income according to its geographical source. We think these rules to be in accord with the policies underlying the net operating loss carryback and foreign tax credit provisions.

Syllabus

Taxable income as defined by the Code more accurately reflects the relative success or failure of the business over the business cycle. The credit is allowed, but in any event never to exceed the amount of United States income tax which would be due, absent the credit, in respect of taxable income from each geographical source. We think the defendant must prevail. The petitions are dismissed.

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528 F. 2d 1401

ESTATE OF EDWARD A. TULLY, SR., EDWARD A. TULLY, JR., PAULINE H. TULLY, AND FRANCIS M. TULLY, CO-EXECUTORS v. THE UNITED STATES

[No. 488–71. Decided January 28, 1976]

ON PLAINTIFFS' AND DEFENDANT'S MOTIONS FOR PARTIAL SUMMARY JUDGMENT

Taxes; estate tax; inclusion in gross estate; death benefits payable to widow; revocable transfer.—Following disallowance of a refund claim, decedent's estate filed this suit seeking to recover an estate tax deficiency assessed and collected by the Internal Revenue Service. Decedent T was employed by corporation T&D of which he and another D each owned 50%. T, D and T&D entered into a contract whereby T&D promised to pay death benefits up to a stated limit to the widows of T and D in consideration for past and future services of T and D. On T's death, T&D paid his widow the death benefits called for in the contract. While this suit involves three issues, the only one before the court at ths time is the includability in T's gross estate of the said death benefits, defendant contending that under Sec. 2038(a)(1) or Sec. 2033 of the Internal Revenue Code of 1954, the death benefits must be included in T's gross estate. It is *held* that T effectively transferred his interests in the death benefits before his death to his wife by executing the agreement, that he did not retain any significant powers to "alter, amend, revoke or terminate" the transfer within the meaning of Sec. 2038(a)(1), that he had no Sec. 2033 "interest" in the benefits at the time of his death, and, accordingly, that the death benefits at issue here were not includable in T's gross estate for estate tax purposes. Plaintiffs' motion for partial summary judgment is granted, defendant's cross-motion is denied, and the case is remanded to the trial judge for appropriate further action.

Syllabus

Taxes; estate tax; gross estate, inclusions in; transfer of property at death.

[1] The primary purpose of the estate tax law is to tax the transfer of property at death. If sufficient incidents of ownership in an item of property are given away before death, no tax will be imposed.

Internal Revenue ⇐ 982

Taxes; estate tax; gross estate, inclusions in; revocable transfers.

[2] Where corporate employer T&D, and decedent-employee T and employee D, each one-half owner of T&D, entered into a contract where T&D promised to pay death benefits with limitations as to amount to T's widow, in consideration for T's past and future services to T&D, by executing the contract T, in substance, transferred an interest in the death benefits to his living wife. However, absent reservation of a power to "alter, amend, revoke or terminate" the death benefits transferred within the meaning of Sec. 2038(a)(1) of the 1954 Internal Revenue Code, such death benefits are not includable in T's gross estate for estate tax purposes.

Internal Revenue ⇐ 1002

Taxes; estate tax; gross estate, inclusions in; revocable transfers; power to alter, amend, revoke or terminate.

[3] Although at the time of death decedent-employee T was a half owner of corporate employer T&D, where the facts show that T did not have individual control of T&D and could not, by himself, alter the terms of the death benefit agreement, T did not possess a Sec. 2038(a)(1) power to "alter, amend, revoke or terminate" through his 50% stock ownership. Sec. 2038(a)(1) powers must be demonstrable, real, apparent and evident, not speculative, and do not extend to powers of persuasion. The fact that T might have changed the benefit plan "in conjunction" with T&D and D, does not force the death benefits into T's gross estate; Congress did not intend the "in conjunction" language of Sec. 2038(a)(1) to extend to the mere possibility of bilateral contract modification.

Internal Revenue ⇐ 1002

Taxes; estate tax; gross estate, inclusions in; revocable transfers; power to alter, amend, revoke or terminate.

[4] A Sec. 2038(a)(1) power to "alter, amend, revoke or terminate" a widow's death benefits under an employee-employer agreement in consideration for the employee's past and future services, is not created by the remote possibility that decedent up until his death could have accepted less compensation or terminated his employment. Nor is such power created by the possibility that decedent could have divorced his wife. These possibilities are in the speculative realm and ignore practicalities.

Internal Revenue ⇐ 1002

Taxes; estate tax; gross estate, inclusions in; property in which decedent had an interest; interest v. power.

[5] It was not the intent of Congress in enacting Sec. 2033 respecting property in which a decedent had an interest at time of death that it be an estate tax "catch all." This section taxes property over which the owner has kept so much control that he has never really transferred it. "Interest" as used in Sec. 2033 connotes a stronger control than "power" as used in Sec. 2038(a)(1).

Internal Revenue ⇐ 994

Robert J. Tyrrell for plaintiff. *Donald L. Mooers*, attorney of record. *Ash, Bauersfeld, Burton & Mooers*, of counsel.

William Kalish, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant.

Before DURFEE, *Senior Judge*, DAVIS and KUNZIG, *Judges*.

KUNZIG, *Judge*, delivered the opinion of the court:

The single issue presented in this estate tax case is the includability in decedent Edward A. Tully, Sr.'s gross estate of death benefits paid directly to Tully's widow by his employer. Plaintiffs (co-executors) move for partial summary judgment[1] claiming that no estate tax provision compels such treatment. Defendant's cross-motion counters that the death benefits must be added to the gross estate as required either by section 2038(a)(1) or section 2033 of the Internal Revenue Code of 1954. We agree with plaintiffs and hold the sum at issue not includable in Tully's gross estate.

The facts in this case are uncontested. Before his death, Tully was employed by Tully and DiNapoli, Inc. (T & D), a company owned 50% by decedent and 50% by Vincent P. DiNapoli. On July 1, 1959, Tully, DiNapoli and T & D entered into a contract whereby T & D promised to pay death benefits to the Tully and DiNapoli widows.[2] Later, in Octo-

[1] The parties' cross-motions for partial summary judgment involve only one of three issues in this lawsuit. The other two issues, valuation of stock held by decedent and taxability of certain *inter vivos* gifts are not now before the court.

[2] The relevant portion of the contract provided:

"Upon the death of the SECOND [Tully] or THIRD [DiNapoli] PARTIES hereto, his widow, if any, shall become entitled to, and the CORPORATION hereby agrees to pay to her, a death benefit equal in amount to twice the annual salary which the CORPORATION had paid to her deceased husband for the year immediately preceding the date of his death."

ber 1963, the same parties amended the 1959 agreement to limit the maximum amount of death payments to $104,000. On March 7, 1964, Tully died. T & D paid his widow the $104,000 called for in the contract.

Because the death benefits were paid directly by T & D to the widow, plaintiffs did not include this sum in Tully's gross estate when they filed the estate tax return. On audit, the Internal Revenue Service (IRS) concluded that the $104,000 was part of Tully's gross estate and assessed an estate tax deficiency. Plaintiffs paid the deficiency, filed a refund claim and by timely petition filed in this court, brought the present action after the IRS disallowed their claim.

In essence, plaintiffs say section 2038(a)(1)[3] is inapplicable because Tully never transferred an interest in the death benefits, either at the time of their creation or thereafter, and even if he had, he kept no power to "alter, amend, revoke or terminate" the interest. Further, plaintiffs assert, decedent had no "interest" in the death benefits at the time of his death within the meaning of estate tax section 2033.[4] Defendant takes an opposing viewpoint. It contends that Tully made a transfer of his interest in the benefits prior to his death, but kept a power to "alter, amend, revoke or terminate" such transfer until the time of his death. Defendant claims this power requires addition of the benefits to Tully's gross estate under section 2038(a)(1). Alternatively, the Government argues, Tully still had sufficient "interest" in the benefits at the time of his death to force the $104,000 into his gross estate under section 2033.

The Government relies only on sections 2038(a)(1) and 2033, and no others, in its argument that the death benefits at issue here are includable in Tully's gross estate.

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[3] "The value of the gross estate shall include the value of all property * * * *to the extent of any interest* therein of which the decedent has at any time *made a transfer* * * * *where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power* (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), *to alter, amend, revoke, or terminate.* * * *" Int. Rev. Code of 1954, § 2038(a)(1). (Emphasis added).

[4] "The value of the gross estate shall include the value of all property *to the extent of the interest therein* of the decedent at the time of his death." Int. Rev. Code of 1954, § 2033. (Emphasis added).

Defendant's contentions, specifically its argument that sections 2038(a)(1) and 2033 must be treated as virtually identical, suggest at the outset that we consider the basic philosophy of estate tax law. As enacted by Congress, the primary purpose of the estate tax is to tax "the transfer of property at death." C. Lowndes & R. Kramer, Federal Estate and Gift Taxes § 2.2 (3d Ed. 1974). If sufficient incidents of ownership in an item of property are given away before death, no tax will be imposed. Since all estate tax statutes are directed at taxing property transferred at death, it can become easy to confuse their operation or to apply them in an overlapping fashion.

Within this context, the two estate tax sections involved in the instant case, 2038(a)(1) and 2033, both impose a tax on property transferred at death. However, they are directed at two different situations. Section 2038(a)(1) is specific in its terms. It taxes property which an individual has given away while retaining enough "strings" to change or revoke the gift. Section 2033 [5] is more general in its approach, and taxes property which has never really been given away at all.

Certain of defendant's arguments misconstrue this basic difference between section 2038(a)(1) and section 2033. By suggesting that the same "controls" over property which might represent a section 2038(a)(1) "power" can also be viewed as a section 2033 "interest," the Government attempts to turn section 2033 into an estate tax "catch all." This was not the intent of Congress in enacting section 2033. Congress has provided a "catch all" in the income tax statutes.[6] It has not done so in the estate tax area. *Estate of Spiegel* v. *Commissioner*, 335 U.S. 701, 714 (1949). *Cf. Helvering* v. *Safe Deposit & Trust Co.*, 316 U.S. 56 (1942); *United States* v. *Field*, 255 U.S. 257 (1921).[7] Therefore, defendant's efforts to treat the two sections as virtually identical by the "catch all" method are misplaced.

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[5] Section 2033 applies to "interests" in property, but interest is not defined in the statute.

[6] Int. Rev. Code of 1954, § 61 provides: "* * * [G]ross income means all income from whatever source derived. * * *"

[7] *Spiegel* construed the 1939 equivalent of section 2033. Congress has not added any "catch all" language to the estate tax since the enactment of the earlier section.

In accordance with this analysis, our inquiry takes two avenues. First, did Tully transfer the death benefits but keep a power to change or revoke them until the time of his death? If so, section 2038(a)(1) applies. Second, did Tully have an "interest" in the benefits at his death? If he had an "interest," section 2033 applies.

We find that Tully effectively transferred his interests in the death benefits before his death, determine that he did not keep any significant powers to "alter, amend, revoke or terminate" the transfer and conclude that he had no "interest" in the benefits at the time of his death. We, therefore, hold that the death benefits at issue here were not includable in Tully's gross estate.

I. Section 2038(a)(1):

Defendant argues that Tully transferred an interest in the death benefits at some point prior to his death and kept a section 2038(a)(1) power to "alter, amend, revoke or terminate" the enjoyment of the benefits after the transfer until his death. Plaintiffs counter that there was no "transfer" in the 1959 contract or thereafter because decedent never had any interest in the benefits which he could transfer. Even if a transfer is found, plaintiffs claim Tully did not keep a section 2038(a)(1) "power" after such transfer.

Contrary to plaintiffs' position, Tully did transfer an interest in the death benefits to his wife by executing the 1959 contract. In one of the three death benefit plans at issue in *Estate of Bogley* v. *United States*, 206 Ct. Cl. 695, 514 F. 2d 1027 (1975), the decedent (an employee, officer, director and 34% shareholder) entered into an enforceable contract with his employer. In consideration of decedent's past and future services, the employer promised to pay decedent's *widow* or the estate two years' salary after his death. We found that where decedent was married at the time of the execution of the contract he "* * * did make a transfer of his interest to his wife during his lifetime by making the contract with [the employer]." *Bogley*, *supra*, 206 Ct. Cl. at 715, 514 F. 2d at 1039. In the instant case, the basic facts are nearly identical. The 1959 agreement looked to Tully's past and future services to T & D for consideration. The benefits here were also pay-

able to the "widow" and decedent was married at the time of the 1959 contract. Tully in substance, if not in form, made a gift of a part of his future earnings to his wife.

However, within the meaning of section 2038(a)(1), Tully did not keep a power to "alter, amend, revoke or terminate" the death benefit transfer after the 1959 contract. There was no express reservation of such power in either the 1959 or 1963 contracts and no indication in the record of any other express agreements in which Tully obtained a section 2038(a)(1) power.

The Government implies that Tully's 50% stock ownership of T & D gave him unfettered power to change the death benefit plan to suit his own tastes. The facts do not bear this out. To the contrary, Tully's every movement could have been blocked by the other 50% shareholder. Tully did not have individual control of T & D and could not, by himself, alter the terms of the death benefit agreement.[8] As stated by the court in *Harris* v. *United States*, 29 Am. Fed. Tax R. 2d 1558 (C.D. Cal. 1972), section 2038(a)(1) powers must be *demonstrable*, *real*, *apparent* and *evident*, not speculative. *See also*, *Hinze* v. *United States*, 29 Am. Fed. Tax R. 2d 1553 (C.D. Cal. 1972). We agree with this test and find Tully did not have a section 2038(a)(1) power to "alter, amend, revoke or terminate" through his 50% stock ownership in T & D at the time of his death.

Moreover, the death benefits are not includable in Tully's gross estate despite the fact that Tully *might* have altered, amended, revoked or terminated them in conjunction with T & D and DiNapoli. A power to "alter, amend, revoke or terminate" expressly exercisable in conjunction with others falls within section 2038(a)(1), but "power" as used in this section does not extend to *powers of persuasion*. If section 2038(a)(1) reached the possibility that Tully might con-

[8] In effect, defendant asks us to hold that corporate control constitutes a section 2038(a)(1) "power." In *United States* v. *Byrum*, 408 U.S. 125 (1972) (Justices White, Brennan, and Blackmun dissenting), the Supreme Court rejected the Government's argument that the corporate control could provide a section 2036 right to alter beneficial enjoyment of trusts. The Court specifically noted the vagaries and uncertainty which a corporate control test would produce in the estate tax area. *Id.* at 138, n. 13.

Since we find that Tully did not have *control* of T & D, we need not reach the equally complex question of whether corporate control might give rise to a section 2038(a)(1) "power."

vince T & D and DiNapoli to change the death benefit plan, it would apply to *speculative powers*. Section 2038(a)(1) cannot be so construed.[9] *Harris*, *supra*; *Hinze*, *supra*. In addition, if section 2038(a)(1) applies to situations where an employee *might* convince an employer to change a death benefit program, it would sweep all employee death benefit plans into the gross estates of employees. It would always be at least possible for an employee to convince the employer that it would be to their mutual benefit to modify the death benefit plan. In light of the numerous cases where employee death benefit plans similar to the instant plan were held not includable in the employee's gross estate,[10] we find that Congress did not intend the "in conjunction" language of section 2038(a)(1) to extend to the mere possibility of bilateral contract modification. Therefore, merely because Tully might have changed the benefit plan "in conjunction" with T & D and DiNapoli, the death benefits are not forced into Tully's gross estate.

Tully also did not obtain a section 2038(a)(1) "power" from the remote possibility that he could have altered the amount of death benefits payable to his widow by changing his compensation scheme. The death benefits here were to be paid based on decedent's annual salary. From this, defendant reasons that up until the time of his death, Tully could have accepted lesser compensation or terminated his employment in order to alter or revoke the death benefits.[11] In practical terms, we reject this *possibility*. This is not a factor

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[9] There is no evidence in the record that the 1963 modification resulted from a demonstrable, real, apparent and evident power by Tully to coerce DiNapoli and T & D to effect the change. At best, it appears that the parties were mutually convinced that the clarification was desirable.

[10] *See, e.g., Estate of Kramer* v. *United States*, 186 Ct. Cl. 684, 406 F. 2d 1363 (1969); *Hinze, supra*; *Harris, supra*; *Molter* v. *United States*, 146 F. Supp. 497 (E.D. N.Y. 1956); *Estate of Barr* v. *Commissioner*, 40 T.C. 227 (1963).

[11] Defendant does not argue that the failure to set a specific dollar amount on the death benefits gave Tully a section 2038(a)(1) "power." Instead it contends this represents a section 2033 "interest" held by decedent until his death. Such position is misplaced. Section 2033 is not a "catch all," but taxes property over which the owner has kept so much control that he has never really transferred it. In this context, the only control that Tully *might* have had over the death benefits by virtue of the failure to set a specific dollar figure was an ability to change or terminate the payments. This is a section 2038(a)(1) "power." Having once given away the benefits, he could not have obtained any part of the benefits to spend for his own use or any one else's use and, therefore, did not have a section 2033 "interest."

which rises to the level of a section 2038(a)(1) "power." An employee might accept lesser compensation or terminate his employment for a myriad of reasons, but to conclude that a motive for such action would be the death benefit plan itself is not only speculative but ridiculous. And we have already made clear that a section 2038(a)(1) "power" cannot be speculative, but must be *demonstrable*, *real*, *apparent* and *evident*. *Harris*, *supra; Hinze*, *supra.* In addition, modification of Tully's employment contract would have required the cooperation of T & D or a breach by Tully. Neither of these two events constitutes a section 2038(a)(1) "power." Further, it is a common practice to "peg" employee death benefit plans to the employee's salary. To our knowledge, no court has ever held that such practice subjects death benefits to inclusion in the employee's gross estate. On the contrary, in *Estate of Whitworth* v. *Commissioner*, 22 CCH Tax Ct. Mem. 177 (1963), the court concluded that although the decedent could have terminated his widow's benefits by leaving his employ or by breaching his employment contract, the death benefits at issue were *not* includable in his estate as a section 2038(a)(1) revocable transfer. Due to the practicalities of death benefit contracts and using the rationale of the *Whitworth* case, we hold that no section 2038(a)(1) power was created by the remote possibility that Tully might have changed the amount of death benefits prior to his death.

Finally, Tully did not retain a section 2038(a)(1) "power" to revoke or terminate the transfer to his wife by virtue of the *possibility* that he could have divorced her. The contract called for T & D to make the death benefit payments to Tully's *widow*. It might be argued that Tully could have divorced his wife to terminate her interest in the death benefits,[12] but again such an argument ignores practicalities, reduces the term "power" to the speculative realm, and is not in accord with prior cases. In reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death

[12] Again, the Government fails to make such argument in the section 2038(a)(1) context. Rather it contends that this possibility left Tully with a section 2033 "interest" in the benefits until his death. Since the possibility of divorce might represent a section 2038(a)(1) 'power", we consider it in this context despite defendant's failure so to argue.

benefits approaches the absurd. Further, in various cases, death benefits payable to the "widow", *Estate of Porter* v. *Commissioner*, 442 F. 2d 915 (1st Cir. 1971), or "wife", *Estate of Kramer* v. *United States*, 186 Ct. Cl. 684, 406 F. 2d 1363 (1969), were not thereby held includable in the gross estate.[13] The possibility of divorce in the instant situation is so *de minimis* and so speculative rather than *demonstrative*, *real*, *apparent* and *evident* that it cannot rise to the level of a section 2038(a)(1) "power." *Harris*, *supra; Hinze*, *supra.* Thus the use of "widow" in the death benefit contract did not give Tully a real power to revoke or terminate the death benefit transfer to his wife.

In short, in the 1959 contract Tully transferred certain interests to his wife by obtaining T & D's promise to pay death benefits. While it may be argued that Tully kept a certain *de minimis* association with the death benefit plan, such association never rose to the dignity of a power to "alter, amend, revoke or terminate" the transfer. In *Kramer*, *supra*, we held that a substantially similar plan did not create section 2038(a)(1) powers. The facts here are not significantly different. Therefore, section 2038(a)(1) does not operate to compel inclusion of the death benefits in decedent's gross estate.

II. Section 2033:

Nor does section 2033 require addition of the benefits to Tully's gross estate. The Government argues that corporate control, "pegging" the benefits to Tully's salary, and naming "widow" as beneficiary constituted section 2033 "interests" kept by Tully until his death. We found above that these facts did not give rise to a section 2038(a)(1) "power." We also determine that they did not create a section 2033 "interest."

Having found that Tully transferred the death benefits to his wife and that he could not reach them for his own use, he could not have kept a section 2033 "interest." The *de minimis* associations Tully may have still had with the benefits are

[13] In *Kramer*, the death benefits were payable to "wife, Carrie Kramer." Using the same argument, since Kramer could have divorced his wife, the Government would *appear* in the instant case to be disputing the *Kramer* section 2038(a)(1) rationale. Yet the Government did not so argue.

not strong enough to force a conclusion that decedent never transferred his interests in the benefits to his wife.

Defendant would use section 2033 as a "catch all." The simple answer to this is that section 2033 is not a "catch all," *Spiegel*, *supra*, but applies to situations where decedent kept so much control over an item of property that in substance he still owns the property. "Interest" as used in section 2033 connotes a stronger control than "power" as used in section 2038(a)(1). If controls over property cannot rise to the dignity of section 2038(a)(1) "powers" they equally cannot create section 2033 "interests." In the instant case, having failed to establish that corporate stock ownership, "pegging" the benefits to Tully's salary and naming the "widow" as beneficiary created section 2038(a)(1) "powers," defendant equally fails to demonstrate that the same facts create section 2033 "interests."

In summary, we have considered an employee plan in which the employee transferred death benefits to his wife, but kept until his death certain tangential associations with the plan. These *de minimis* associations did not rise to the level of section 2038(a)(1) "powers" to "alter, amend, revoke or terminate" the transfer, and did not constitute "interests" sufficient to force the conclusion that section 2033 applies. Therefore, the death benefits at issue here were not includable in Tully's gross estate.

Accordingly, plaintiffs' motion for partial summary judgment is granted and defendant's cross-motion for partial summary judgment is denied. The case is remanded to the Trial Judge for determination of the amount due plaintiffs under Rule 131(c) by reason of this judgment and such other action as may be necessary, not inconsistent with the above.

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530 F. 2d 923

GENERAL FOODS CORPORATION v. THE UNITED STATES

[No. 70-73. Decided January 28, 1976]

OPINION

Taxes; income tax; capital gains and losses; bonds and other evidence of indebtedness; retirement; original issue discount; ordi-

Syllabus

nary income v. short-term capital gain.—Plaintiff seeks to recover an assessed and paid deficiency in income tax for taxable year 1959 (April 1, 1958–March 31, 1959), plus interest. This case is before the court on a stipulation of facts. During plaintiff's taxable year 1959 it purchased for investment certain non-interest-bearing corporate notes at amounts less than their face values. Plaintiff held each note for less than 6 months and upon retirement in taxable year 1959 at maturity plaintiff received the face amount of each note. The amount received which exceeded the amount paid for each note was original issue discount. All of the notes were issued after December 31, 1954 and before May 27, 1969. On its Federal income tax return for taxable year 1959, plaintiff reported short-term capital gains on the amounts received over and above the purchase prices. The Commissioner of Internal Revenue assessed a deficiency, treating as interest income rather than as short-term capital gain the amounts received over and above the purchase prices. Plaintiff's claim for refund was disallowed and this suit followed. Plaintiff argues that Sec. 1232(a)(1) of the Internal Revenue Code of 1954 makes the retirement of the notes equal to an exchange and that an exchange of a capital asset results in capital gain. It is *held* that original issue discount is separable from the note itself and gain attributable to original issue discount on the notes in issue held by plaintiff for periods of not more than 6 months is taxable as ordinary income on retirement of the indebtedness. Plaintiff is not entitled to recover, judgment is entered for defendant, and the petition is dismissed.

Taxes; income tax; capital gains and losses; bonds and other evidence of indebtedness; retirement; original issue discount; ordinary income v. short-term capital gain.

[1] Section 1232 of the Internal Revenue Code of 1954 is only applicable to capital assets, it does not apply to original issue discount on notes held for 6 months or less. Original issue discount is separable from the note. Any gain attributable to original issue discount on evidences of indebtedness issued after December 31, 1954 and before May 28, 1969 and held by taxpayer for periods of not more than 6 months is taxable as ordinary interest income and not as capital gain.

Internal Revenue ⇐ 410.1

Taxes; income tax; capital gains and losses; bonds and other evidence of indebtedness; retirement; original issue discount; ordinary income v. short-term capital gain.

[2] the term "capital asset" is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time. Sec. 1232(a)(1) of the Code was intended to cover capital gain resulting from retire-

ment of a note held more than 6 months in contrast to original issue discount gain representing compensation for use of money.

Internal Revenue ⇐ 406, 410.1

Statutes; construction and operation; legislative intent; subsequent Congress, opinion expressed by.

[3] The views of a subsequent Congress as to the meaning of statutory ambiguous language of a previous Congress do not carry great weight.

Statutes ⇐ 220

Taxes; civil actions or suits for refund of taxes; claim for refund; necessity for filing.

[4] This court is without jurisdiction to rule upon a ground for refund of a tax not set out in the administrative claim for refund.

Internal Revenue ⇐ 2207.1

David I. Granger, attorney of record, for plaintiff. *Harold D. Murry, Jr.* and *Clifford, Warnke, Glass, McIlwain & Finney*, of counsel.

Richard F. Treacy, Jr., with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Theodore D. Peyser* and *Donald H. Olson*, of counsel.

Before LARAMORE, *Senior Judge*, DAVIS, SKELTON, NICHOLS, KASHIWA, KUNZIG, and BENNETT, *Judges*.

KASHIWA, *Judge*, delivered the opinion of the court:

This action comes before us on a stipulation of facts. The essential facts stipulated are recited below. Each of the parties claims that it is entitled to judgment on said stipulated facts. We hold for the defendant and against the plaintiff for reasons hereafter stated.

This is an action arising under the Internal Revenue Code of 1954 for the taxable year 1959, beginning April 1, 1958, and ending March 31, 1959. Since Section 1232 of the Internal Revenue Code of 1954 is the center of discussion, we shall first quote by footnote its relevant portions.[1]

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[1] SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

"(a) GENERAL RULE.—For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

"(1) RETIREMENT.—Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts re-

Opinion of the Court

Plaintiff, General Foods Corporation, is a corporation duly organized and existing under the laws of the State of Delaware, with its principal place of business at White Plains, New York. The stipulation shows that General Foods Corporation's principal business is the production and sale of a wide variety of food and grocery products, many in package form under nationally advertised brand names. General Foods Corporation is not now, nor has it ever been, a dealer in securities. During the taxable year 1959, plaintiff held promissory notes with no stated interest issued by various corporations. The notes, commonly referred to as commercial paper, were non-registered bearer instruments containing an unconditional promise to pay a specified amount on a specified date at a specified place. Plaintiff purchased each of the notes

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ceived in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

"(2) SALE OR EXCHANGE.—

"(A) GENERAL RULE.—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

"(i) an amount equal to the original issue discount (as defined in subsection (b)), or

"(ii) if at the time of original issue there was no intention to call the bond or other evidence of indebtedness before maturity, an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidence of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity,

"shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months.

"(B) EXCEPTIONS.—This paragraph shall not apply to—

"(i) obligations the interest on which is not includible in gross income under section 103 (relating to certain governmental obligations), or

"(ii) any holder who has purchased the bond or other evidence of indebtedness at a premium.

"(C) DOUBLE INCLUSION IN INCOME NOT REQUIRED.—This section shall not require the inclusion of any amount previously includible in gross income.

"(b) DEFINITIONS.—

"(1) ORIGINAL ISSUE DISCOUNT.—For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. If the original issue discount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity, then the issue discount shall be considered to be zero. For purposes of this paragraph, the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes dividends payable at that time."

* * * * *

[As amended through 1959.]

205-676—76——40

from the issuer or from Goldman, Sachs & Company, a dealer in securities, at an amount less than its face value. The notes were held by plaintiff for periods ranging from 43 days to 181 days. The plaintiff held each note for a period less than six months and at maturity received the face amount from the issuer. Plaintiff retired all of the notes in the taxable year 1959. The notes were purchased by the plaintiff for investment and were not property of a type that would be held in inventory or for sale to customers in the normal course of business. All of the notes involved in this case were issued after December 31, 1954, and before May 27, 1969. The amount received by the plaintiff on retirement of each of the notes which exceeded the amount paid by plaintiff for the note was original issue discount; no part of that amount was attributable to market fluctuations as opposed to the passage of time.

On its Federal income tax return for the taxable year 1959, beginning April 1, 1958, and ending March 31, 1959, plaintiff reported short-term capital gains of $608,598.99. This was the amount received over and above the purchase prices from the retirement at maturity of the total of $90,750,000 non-interest-bearing corporate notes purchased by the plaintiff at a discount and held for less than six months. During the taxable year 1959 plaintiff had net capital loss carryovers from the prior years in the amount of $518,840.74. There is no dispute as to this loss carryover. Plaintiff claims that it is entitled to deduct the loss carryover from the above-mentioned gain of $608,598.99 because the gain is short-term capital gain.

On October 29, 1965, the Commissioner of Internal Revenue mailed to the plaintiff a statement of tax due, assessing a deficiency in income taxes for the taxable year 1959 in the amount of $345,638 plus interest. Plaintiff paid this amount plus interest on November 8, 1965. The amount of $208,291 of this deficiency assessment resulted from the Commissioner treating as interest income rather than as short-term capital gain the amount of $608,598.99 received by plaintiff over and above the purchase prices on the retirement at maturity of the non-interest-bearing corporate notes purchased by the plaintiff at a discount for investment and held for less than

six months. On November 6, 1967, plaintiff filed a claim for refund of this amount of $208,291 plus the interest paid thereon together with interest as provided by law, representing that part of the assessed deficiency attributable to treating as interest income rather than short-term capital gain the amounts over and above the purchase prices, received by plaintiff on the retirement of the corporate notes. On March 1, 1971, the Commissioner of Internal Revenue disallowed in its entirety plaintiff's claim for refund. This action for refund was filed in this court on February 27, 1973.

Both parties agree that the sole issue presented is whether gain attributable to original issue discount on evidences of indebtedness issued after December 31, 1954, and before May 28, 1969, and held by plaintiff for periods of not more than six months is taxable as short-term capital gain on the retirement of the indebtedness.

The decision in this case rests, as we shall hereafter show, upon Section 1221 but since plaintiff's arguments center on Section 1232, we shall first examine Section 1232. Plaintiff claims that Section 1232 gives capital treatment to the gain in this case. Defendant, on the other hand, states that Section 1232 is not relevant to the original issue discount herein since Section 1232 only deals with notes which are capital assets in the hands of the taxpayer and since original issue discount under case law is not a capital asset, Section 1232 does not apply.

We shall first discuss the history of Section 1232. Section 206(a)(1) of the Revenue Act of 1921, c. 136, 42 Stat. 227, 232, defined the term "capital gain" as "taxable gain from the sale or exchange of capital assets * * *." This provision, without material change, was reenacted by Section 208(a)(1) of the Revenue Act of 1924, c. 234, 43 Stat. 253, 262; by Section 208(a)(1) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 19; by Section 101(c)(1) of the Revenue Act of 1928, c. 852, 45 Stat. 791, 811; and by Section 101(c)(1) of the Revenue Act of 1932, c. 209, 47 Stat. 169, 191.

The question arose as to whether, under these statutes, a redemption (retirement) of bonds constituted a sale or exchange within the meaning of that provision and successor

statutes. A conflict of judicial decisions[2] on the matter led Congress to enact Section 117(f) of the Revenue Act of 1934, c. 277, 48 Stat. 680, 715, which is the predecessor of Section 1232(a)(1). The addition of that provision assured that the retirement of notes would constitute an exchange.

While Section 117(f) served to resolve the question of whether the *retirement* of a note constituted a "sale or exchange," it created a new round of litigation as to whether gain attributable to original issue discount was an amount received in exchange for a capital asset and, consequently, qualified for long-term capital gain treatment. In *Commissioner* v. *Caulkins*, 144 F. 2d 482 (6th Cir. 1944), the Sixth Circuit read Section 117(f) to permit long-term capital gain treatment for the $5,000 gain realized, functionally, as original issue discount. The court noted (at 484) that if the application of Section 117(f) resulted in inconsistencies and inequalities, "the correction of this defect in the operation of the statute is for Congress and not for the courts." The Supreme Court in *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965), subsequently disagreed with the holding of *Caulkins* that the proceeds received upon a face-amount certificate cannot be divided into separate increments which represent interest income and capital gain after other courts, including this court, refused to follow the rationale of the Sixth Circuit. See *Pattiz* v. *United States*, 160 Ct. Cl. 121, 311 F. 2d 947 (1963); *Commissioner* v. *Morgan*, 272 F. 2d 936 (9th Cir. 1959); *Rosen* v. *United States*, 288 F. 2d 658 (3d Cir. 1961); *United States* v. *Harrison*, 304 F. 2d 835 (5th Cir. 1962), *cert. denied*, 372 U.S. 934 (1963).

The legislative history of the revised version of Section 117(f) (Section 1232) indicates that Congress chose to heed the admonition of the court in *Caulkins* to correct, at least partially, a possible defect in the statute which, under the holding of *Caulkins*, allowed the issuing corporation an interest deduction for original issue discount, but taxed the holder at more favorable long-term capital gain rates if the notes were held more than six months. The following language of the Senate Report accompanying the enactment of

[2] See *Fairbanks* v. *United States*, 306 U.S. 436 (1939).

Section 1232 of the 1954 Code graphically illustrates the situation which Congress faced at the time (S. Rep. No. 1622, 83d Cong., 2d Sess. 112 (1954)):

> (C) *Bonds and Other Debt (sec. 1232)*
> (1) *House changes accepted by committee*
> Under section 117(f) of present law, when a corporate or Government bond in registered form or with coupons attached is retired the transaction is treated as a sale or exchange. There is some uncertainty as to the status of proceeds in these transactions, i.e., as capital gain or as interest income where the bond or other evidence of indebtedness has been issued at a discount (see I.T. 3486, 1941-2, C.B. p. 76, as compared with *Comm.* v. *Caulkins*, 144 F. 2d 482). In these cases, that part of the amount received on a sale or exchange which may represent a partial recovery of discount on original issue is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.
> Effective with respect to bonds issued after December 31, 1954, the House bill removes doubt in this area by providing that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income. * * *

The solution to the problem perceived by Congress as a result of *Caulkins* was a limited one. Together with other technical amendments to the old Section 117(f), which amendments have no effect on the instant problem, Congress added subsection (a)(2) to Section 1232 to plug the revenue loss resulting from the allowance, under *Caulkins*, of long-term capital gain treatment.

Congress reenacted most of the text of Section 117(f) as Section 1232(a) of the 1954 Code and specifically added the limiting language "which are capital assets" to the language "bonds, debentures, notes, or certificates or other evidences of indebtedness." It explained this addition as follows (S. Rep. No. 1622, *supra*, at 434):

> Section 117(f) does not itself extend capital-gain treatment to any transaction but simply provides one of several requirements for such treatment on retirement of certain securities. Paragraph (2) of this section [Section 1232], however, provides specifically for capital-gain treatment and, therefore, the phrase is inserted in the first sentence of this section to the effect that this section only applies to bonds and other evidences of in-

debtedness *which are capital assets* in the hands of the taxpayer. * * * [Emphasis supplied.]

We turn now from the history to the present positions of the parties. Plaintiff first argues that Section 1232(a)(1) makes the retirement of these notes equal to an exchange. Since the section does not provide for special treatment of original issue discount for notes held six months or less as it does for original issue discount on notes held more than six months in Section 1232(a)(2), notes held for six months or less fall under Section 1232(a)(1). Their retirement is treated as an exchange and an exchange of a capital asset results in capital gain.

This is the point at which the parties separate. The defendant states that Section 1232(a)(1) does not apply; in fact, none of Section 1232 applies. In Section 1232(a) the general rule refers to notes "which are capital assets in the hands of the taxpayer." Defendant argues that under case law the original issue discount is separable from the note and is not a capital asset. Since Section 1232 is only applicable to capital assets, it does not apply to original issue discount on notes held for six months or less. Therefore, we must examine the case law to determine how this item should be treated.

It has been held by the Supreme Court and other courts that an item of ordinary income derived from an income-producing capital asset retained its character even though sold as part of property which was a capital asset.[3] In *United States* v. *Midland-Ross Corp.*, *supra*, the Supreme Court held that original issue discount was ordinary income and not capital gain. The Court held as follows at 56–57:

[3] *Watson* v. *Commissioner*, 345 U.S. 544 (1953) [profit from sale of an orange grove attributable to unmatured crop was ordinary income]; *Commissioner* v. *Gillette Motor Transport, Inc.*, 364 U.S. 130 (1960) [award for wartime possession of trucking company by Government was rental income and not capital gain from involuntary conversion]; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260 (1958) [consideration for assignment of oil payment right carved out from a larger mineral interest producing ordinary income was held to be taxable as ordinary income]; *Tunnell* v. *United States*, 259 F. 2d 916 (3d Cir. 1958) [proceeds of sale of interest in law partnership, to the extent attributable to accounts receivable, were taxable as ordinary income]; *Fisher* v. *Commissioner*, 209 F. 2d 513 (6th Cir. 1954), *cert. denied*, 347 U.S. 1014 [proceeds of sale of notes representing defaulted interest were ordinary income].

* * * Although original issue discount becomes property when the obligation falls due or is liquidated prior to maturity and § 117(a)(1) defined a capital asset as "property held by the taxpayer," we have held that

> "not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset. This Court has long held that the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." *Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130, 134.

See also *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 52. In applying this principle, this Court has consistently construed "capital asset" to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income. * * * [Footnote omitted.]

In an earlier decision in *Pattiz* v. *United States*, *supra*, this court held as follows:

> We think the discount at which these notes were sold was in lieu of the payment of interest on them, and that the difference in the amount paid for them and the amount at which they were redeemed was ordinary income. In our opinion it was not intended by § 117(f) of the Internal Revenue Code of 1939 to treat it as a capital gain. [160 Ct. Cl. at 128, 311 F. 2d at 950.]

Judge Whitaker in his *Pattiz* opinion examines the relevant cases of several circuits and comes to the conclusion that Section 117(f), the predecessor of Section 1232(a)(1), was intended to cover capital gain resulting from the retirement of a note in contrast to original issue discount gain representing compensation for the use of money.

That decision agrees with the Third Circuit's conclusion in *Rosen* v. *United States*, *supra*. In *Rosen* the taxpayer argued that Section 1232(a)(1) was an overriding statute which prevented original issue discount from being taxed as interest under Section 61. The court at 661 stated the issue to be:

> * * * whether the requirement of Section 1232(a)(1) that amounts received on retirement of certain "evidences of indebtedness shall be considered as amounts received in exchange therefor" is tantamount to saying that the entire increment realized in such an exchange must be taxed as capital gain rather than ordinary income.

The court then looked at the tax treatment of fully earned increments upon the sale or exchange of capital assets and concluded that the general rule applies: the right to receive ordinary income from a capital asset is not changed into capital gain upon the sale of that asset together with the right. Section 1232(a)(1) did not abrogate that rule but, rather, provided for capital treatment for the capital increment which was realized upon retirement.

Plaintiff seizes upon a sentence in a Senate Committee on Finance Report to the Tax Reform Act of 1969, Pub. L. No. 91–172, 83 Stat. 487,[4] to argue that Section 1232 was intended to overrule *Midland-Ross*, *supra*. This statement was made without any basis in the 1954 version of Section 1232. The views of a subsequent Congress as to the meaning of ambiguous language of a previous Congress do not carry great weight.[5] An attempt to amend legislation of a previous Congress by Committee Report must be rejected.

Plaintiff also states that it should prevail because the Commissioner unlawfully discriminated in favor of similarly situated taxpayers. The basis of this claim is that the Commissioner failed to tax as ordinary income original issue discount on evidences of indebtedness held for six months or less by nonresident alien individuals and foreign corporations. In plaintiff's claim for refund no mention is made of

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[4] S. Rep. No. 91–552, 91st Cong., 1st Sess. (1969) at 148:

"* * * In * * * [the case of Government evidences of indebtedness or in the case of pre-October 10, 1969, corporate evidences of indebtedness] gain on the sale or exchange of a bond or other evidence of indebtedness which is a capital asset in the hands of the taxpayer but which has not been held by the taxpayer for more than 6 months is to be treated as a short-term capital gain as under present law."

[5] *United States* v. *Price*, 361 U.S. 304, 313 (1960); *United States* v. *Philadelphia National Bank*, 374 U.S. 321, 348–49 (1963); *Waterman Steamship Corp.* v. *United States*, 381 U.S. 252, 269 (1965); *United States* v. *Southwestern Cable Co.*, 392 U.S. 157, 170 (1968); *Brown* v. *United States*, 192 Ct. Cl. 203, 210, 426 F. 2d 355, 357 (1970); and *Humble Oil & Refining Co.* v. *United States*, 194 Ct. Cl. 920, 932, 442 F. 2d 1362, 1369 (1971).

a claim of unlawful discrimination. Accordingly, this court is without jurisdiction to rule upon a claim not set out in plaintiff's claim for refund. See Section 7422(a) of the 1954 Code and Treas. Reg. § 301.6402-2(b)(1) (1956); *Union Pacific R.R.* v. *United States*, 182 Ct. Cl. 103, 108, 389 F. 2d 437, 442 (1968), and the cases cited therein.

We find for the defendant and against the plaintiff. Plaintiff's petition is dismissed. Judgment is entered for the defendant and against the plaintiff.

DAVIS, *Judge*, concurring in the result:

My vote to dismiss the petition is not founded on the use in section 1232 of "capital assets," the primary purpose of which I take to be to separate securities held for investment from those held in the ordinary course of trade or business. Rather, I am moved by the simple fact that section 1232 fails to deal at all with original issue discount on securities held for no more than six months, and therefore must conclude that the applicable rule, even under the 1954 Code, was the "economic reality" of *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965), that such discount is equivalent to interest. Taxpayers can point to no part of section 1232 which lays down the treatment for original issue discount on bonds held for no more than six months. Subsection (a)(2)(A), as everyone agrees, is restricted on its face to evidences of indebtedness held for more than six months; subsection (a)(1) is no more than the equivalent of section 117(a)(4) of the 1939 Code which the Court in *Midland-Ross* held not a bar to treating original issue discount as ordinary income. The text of section 1232, in the initial 1954 Code, did not deal at all, as I read it, with the problem of original issue discount on bonds retained no more than half-a-year.

I agree with the taxpayer that the Congress which enacted that section may well have thought that original issue discount on such securities would thereafter be dealt with as short-term capital gain. But that was because that Congress

mistakenly believed that *Commissioner* v. *Caulkins*, 144 F. 2d 482 (C.A. 6, 1944)—which had held all original issue discount on bonds held for investment to be capital gain—would continue as good tax law except insofar as the rule was changed in section 1232 for the longer-term securities. And the probability is that that same Congress did not think it important to change the *Caulkins* rule for the no-more-than-six-months bonds because short-term capital gain is normally taxed at ordinary income rates. (The peculiar situation now before us does not seem to have been in anyone's mind.)[1] At any rate, it seems to me clear that the Congress which enacted the 1954 Code did not adopt, in section 1232 or another provision, any rule for original issue discount on evidences of indebtedness held for no more than six months; it simply left that subject uncovered by specific rule. The result is that, since Congress has not imbedded any part of *Caulkins* in the Code, we are required to apply the rule of *Midland-Ross* which superseded and overruled *Caulkins*. Congress is not legislating when, instead of laying down a statutory rule, it leaves a subject alone, even though it may be content to let the matter be covered by a lower-court decision which later happens to be set aside by the Supreme Court. *Cf. Helvering* v. *Hallock*, 309 U.S. 106, 119–22 (1940).[2]

As for the claim of unlawful discrimination, I would rest squarely on the ground that the taxation of non-resident foreign taxpayers raises such different considerations that it cannot validly be compared, for equal protection purposes, to the taxation of domestic taxpayers.

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[1] There is no solid indication that the section 1232 Congress affirmatively desired that original issue discount on bonds held for no more than six months should be treated as capital gain even if *Caulkins* should be overturned by the Supreme Court.

[2] The views of a later Congress on the earlier law have " 'very little, if any, significance.' " *United States* v. *Southwestern Cable Co.*, 392 U.S. 157, 170 (1968). Therefore weight should not be given to the 1969 Senate report which said that "In * * * [the case of pre-1969 corporate indebtedness and Government bonds], gain on the sale or exchange of a bond or other evidence of indebtedness which is a capital asset in the hands of the taxpayer but which has not been held by the taxpayer for more than 6 months is to be treated as a short-term capital gain as under present law." S. REP. No. 91–552, 91st Cong., 1st Sess. 148 (1969) (1969–3 CUM. BULL. 513).

Syllabus

530 F. 2d 1367

BOISE CASCADE CORPORATION AND SUBSIDIARY COMPANIES v. THE UNITED STATES

[Nos. 321–69 & 81–71. Decided January 28, 1976]

OPINION

Taxes; income tax; original issue discount; ordinary income v. short-term capital gain; accounting method; accrual basis; deferment of income; contract for services.—In these consolidated cases, plaintiffs seek to recover income taxes, plus interest thereon, assessed and paid for years 1955 through 1961. Plaintiff Ebasco entered into contracts to perform engineering and similar services, and under its consistent method of accounting billed and accrued receipts for such services prior to the tax year in which the services generating such amounts were rendered, and reported the amounts as income in the tax year of performance. The Commissioner of Internal Revenue determined that plaintiffs' deferral method of accounting did not clearly reflect income and required a change. During 1955 through 1961 plaintiffs purchased at an original issue discount commercial paper issued after December 31, 1954, and held certain of the paper for not more than 6 months. The Commissioner held that the gains therefrom should be treated as ordinary interest income. It is *held* under the rationale of *General Foods Corp.* v. *United States* (decided today), ante at 606 that the gains attributable to original issue discount, on evidences of indebtedness issued after December 31, 1954 and before May 28, 1969 and held by plaintiffs for not more than 6 months are ordinary interest income and not short-term capital gain. It is *also* held that plaintiffs' method of accounting for income from the services contracts is in accordance with generally accepted accounting principles and clearly reflects income, and that the Commissioner's determination to the contrary and in requiring a change was an abuse of discretion under Sec. 446(b). The petitions with respect to original issue discount are dismissed, and judgment is entered for plaintiffs with respect to the accounting issue, the amount of recovery to be determined in further proceedings.

Taxes; income tax; capital gains and losses; bonds and other evidence of indebtedness; original issue discount; ordinary income v. short-term capital gain.

[1] Gains attributable to original issue discount on evidences of indebtedness issued after December 31, 1954 and before May 28, 1969 and held by taxpayer for periods of not more than 6 months are ordinary income rather than short-term capital gains.

Internal Revenue ⇨ 410.1

Taxes; Revenue Rulings; discriminatory rulings.

[2] Regarding the unlawful discrimination contention of plaintiffs

Syllabus

that the Commissioner failed to tax as ordinary income original issue discount on evidence of indebtedness held for six months or less by nonresident alien individuals and foreign corporations, taxation of nonresident foreign taxpayers raises such different considerations that it cannot be compared, for equal protection purposes, to the taxation of domestic taxpayers.

Constitutional Law ⇐ 229.2

Taxes; income tax; accounting method; accrual basis; deferment of income.

[3] Where accrual basis taxpayer consistently bills for contracted services prior to the tax year in which the services are rendered and credits such amounts to "unearned income" and treats the amounts as liabilities excludable from gross income, and thereafter when the services are performed in the subsequent tax years it includes the amounts in income for said subsequent tax year, such method is in accordance with generally accepted accounting principles.

Internal Revenue ⇐ 1334

Taxes; income tax; accounting methods; accrual basis; deferment of income.

[4] While generally accepted methods of accounting are of probative value and are treated with respect by Treas. Reg. § 1.446–1(a)(2), they are not necessarily synonymous with the proper tax accounting to be afforded an accrual item in a given situation. Thus, although the method of an accrual basis taxpayer for deferral of unearned income may be in full accord with generally accepted accounting principles, taxpayer must also show that its method clearly reflects income for purposes of the Internal Revenue Code.

Internal Revenue ⇐ 1334

Taxes; income tax; accounting methods; generally.

[5] Tax accounting starts from the premise of a need for certainty in collection of revenues and focuses on the concept of ability to pay.

Internal Revenue ⇐ 1331

Taxes; income tax; accounting methods; accrual basis; deferment of income.

[6] Taxpayer's consistent method of accounting under which amounts received are accrued and reported as income only in the taxable year in which the contracted services generating such amounts are rendered, clearly reflects income as required by Sec. 446 of the Internal Revenue Code of 1954 where the contractual obligation to perform is fixed and definite.

Internal Revenue ⇐ 1334

Taxes; Commissioner of Internal Revenue; abuse of discretion; accounting method; accrual basis; deferment of income.

[7] Where taxpayer in its method of accounting accrues receipts and reports the amounts as income only in the taxable year in which

Per Curiam

the contracted services generating such amounts are rendered, the Commissioner's proposal to tax as income the amounts billed in the prior tax year but not earned by performance, and, on the other hand, where performance of services precedes billing, the Commissioner would tax amounts as income at the time the services are rendered although, under the contracts, taxpayer has no present right to bill or receive payment of such amounts, distorts income rather than clearly reflecting it. Thus, in determining that taxpayer's method of accounting failed to reflect income clearly for income tax purposes and in requiring taxpayer to follow the proposed method, the Commissioner abused his discretion under Sec. 446(b) of the Internal Revenue Code of 1954 and within the meaning of the authority of *Mooney Aircraft, Inc.* v. *United States*, 420 F. 2d 400 (5th Cir. 1969), and *Artnell Co.* v. *Commissioner*, 400 F. 2d 981 (7th Cir. 1968).

Internal Revenue ⇐ 1334

Norton Kern, attorney of record for plaintiff. *Lawrence C. Wilson*, *Reid & Priest*, of counsel.

Donald H. Olson, with whom was *Assistant Attorney General Scott P. Crampton*, for defendant. *Theodore D. Peyser*, of counsel.

Before LARAMORE, *Senior Judge*, DAVIS, SKELTON, NICHOLS, KASHIWA, KUNZIG, and BENNETT, *Judges*.

PER CURIAM: These are consolidated cases, in which plaintiffs seek the recovery of nearly $2,400,000 in income taxes plus interest thereon, paid for the years 1955 through 1961. They now come before the court on exceptions by the parties to the recommended decision filed by Trial Judge Lloyd Fletcher, on September 20, 1974, pursuant to Rule 134(h), having been submitted to the court on the briefs and oral argument of counsel. He held for the plaintiffs on all the significant issues. After briefing and oral argument, the court agrees with the trial judge in part, and disagrees in part. Our disagreement extends to all the portions of the opinion that deal with plaintiffs' gains from original issue discount. In *General Foods Corporation* v. *United States*, *ante*, at the stipulated facts as to this issue offer no legal distinction from the found facts at bar. The court has there held that the gains attributable to original issue discount, on evidences of indebtedness issued after December 31, 1954, and before May

28, 1969, and held by plaintiff for periods of not more than six months, were ordinary income rather than short term capital gains. Accordingly, the discount was taxable currently as earned by these accrual basis taxpayers. In view of our full statement of reasons in *General Foods*, to which reference is made, it is unnecessary to repeat it here. The fact findings are left standing. Though not printed herewith, they have been furnished to the parties, and will suffice to document the identity of issues.

With respect to the claim of unlawful discrimination in favor of nonresident taxpayers, in that the Commissioner failed to tax as ordinary income original issue discount on their indebtedness held for six months or less, the court is of the opinion that the taxation of nonresident foreign taxpayers raises such different considerations that it cannot be compared, for equal protection purposes, to the taxation of domestic taxpayers.

We agree substantially with the portions of the recommended opinion that hold the Commissioner of Internal Revenue to have abused his discretion under IRC § 446(b), in determining that Ebasco's method of accounting failed to reflect income clearly for Federal Income Tax purposes and in requiring a change in such method as set forth below. The portions of the said trial judge's opinion that deal with this subject are set forth below and are adopted as our opinion with some modifications made by the court.*

The petitions with respect to original issue discount are dismissed, and judgment is entered for plaintiffs with respect to the accounting issue, with the determination of the amount of recovery to be reserved for further proceedings under Rule 131(c) in accordance with this opinion.

Trial Judge Fletcher's opinion, as modified by the court, follows:

The plaintiffs are Boise Cascade Corporation and several of its subsidiary companies. The original petition was filed by Ebasco Industries Inc. and its subsidiary companies which had filed consolidated tax returns for the taxable years 1955 through 1958. Later, Ebasco Industries was merged with

*The concurring opinion of Judge Davis follows the opinion of the trial judge which has been adopted as modified by the court.

Boise Cascade in a non-taxable transaction, and the necessary steps were taken thereafter to consolidate the actions now before the court.

Ebasco Industries was engaged in holding various investments during the years 1955 through August 31, 1969, the date of its merger into Boise Cascade. These investments included marketable securities, short-term investments, and ownership interests in various operating subsidiaries which were (and continue to be) engaged primarily in rendering engineering, construction, architectural, and consulting services. Two of such subsidiaries were Ebasco Services, Inc. (Ebasco) and Chemical Construction Corporation (Chemical Construction). Ebasco Industries owned stock possessing at least 80 percent of the voting power of all classes of stock of those subsidiary corporations.

The plaintiffs' annual shareholder reports included a certification by independent accountants that the financial statements were prepared in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

In its business, Ebasco Services enters into contracts to perform engineering and similar services. Under the various terms of these contracts, Ebasco is entitled to bill fixed sums either in monthly, quarterly, or other periodic installments, plus such additional amounts as may be provided for in a particular contract. Depending on the terms of the different contracts, payments may in some cases be due prior to the annual period in which such services are to be performed, and in some cases subsequent thereto.

For a number of years prior to 1959 and continuing to the time of trial, Ebasco included in its income for both book and tax purposes amounts attributable to services which it performed during the taxable year, a procedure accepted by the Internal Revenue Service on prior audits. Ebasco determined the amounts so earned by dividing the estimated number of service hours or days required to complete the particular contract into the contract price. The resulting quotient represents an hourly or daily rate which is then multiplied by the number of hours or days actually worked on the contract during the taxable year. As the contract is

performed, the rate is adjusted to reflect revised estimates of the work required to complete the contract.

Where Ebasco billed for services prior to the tax year in which they were performed, it credited such amounts to a balance sheet account called "Unearned Income". Where the services were performed in a subsequent period, the "Unearned Income" account was debited, and such amounts were included in an income account called "Service Revenues." The amount recorded in the latter account was included in income for both book and tax purposes. In determining the amount which was to be included in the "Unearned Income" account, the costs of obtaining the contract were not taken into account; [1] and, with the exception of prepaid insurance and similar items, all such amounts were expensed in the tax year during which they were incurred. The amounts in the "Unearned Income" account were treated as liabilities and were excluded from gross income for each tax year consistently in Ebasco's books, records, and shareholder reports, as well as in its tax returns. All of the amounts included in the account during one tax year were earned through the performance of services during the following year and were included in income for such following tax year. When the amounts credited to the "Unearned Income" account were collected, Ebasco had an unrestricted right to the use of such funds.

During the three tax years in issue, an average of over 94 percent of the amounts included in the "Unearned Income" account was received by Ebasco under contracts which obligated it to perform engineering services in connection with the design and construction of electric generating plants. These contracts either required that services be performed by a specified date or required that Ebasco should perform those services "with all reasonable dispatch and diligence," as "expeditiously as possible," or some comparable requirement. The small remaining amounts in the account were received either under contracts which required Ebasco to perform specific services in connection with a specific project of a

[1] These amounts included the cost of preparing bids, proposals and estimates, overhead, advertising, and selling expenses.

client, or required Ebasco to provide consultation and advice on an annual basis for an annual fee.

In addition to its "Unearned" account, Ebasco maintained an "Unbilled Charges" account computed in the same manner as the "Unearned Income" account. The balance in such account represented amounts earned through the rendering of services, or on partially completed contracts, or earned prior to contracting under all of which payment was not then due by the terms of a contract or was not billable and due prior to execution of a future contract. Stated another way, the amounts included in this account were those which Ebasco was not entitled to bill or receive until a year subsequent to the year in which the services were actually rendered. Such amounts were recorded in "Service Revenues" and included in income for tax as well as book purposes in the taxable year in which the services were rendered. Likewise, the costs attributable to the rendering of services which produced the year-end balance in the "Unbilled Charges" account were deducted from gross income in the year such services were rendered. In 1959, 1960, and 1961 there were approximately $405,000, ($56,000), and $179,000 of such net amounts, respectively, carried in the "Unbilled Charges" account.

Plaintiffs' consolidated income tax returns for 1959 through 1961 were audited by the Government, and the amounts in the "Unearned Income" account were included in taxable income for Federal tax purposes. These adjustments were made pursuant to section 446(b) of the 1954 Code under which the Commissioner determined that plaintiffs' deferral method of accounting did not clearly reflect income. During the same examination for the same tax years, no adjustments were made to the "Unbilled Charges" or the "Service Revenues" accounts.

At trial Ebasco presented expert testimony related solely to the accounting practices described above. The sole witness was a qualified certified public accountant and a partner in a major accounting firm. Based on his broad experience with comparable service companies and his personal familiarity with the accounting practices of Ebasco, he expressed his expert opinion with respect to the accounts in issue and the changes made by the Commissioner.

He testified that the method of accounting used by Ebasco which employs both an "Unearned Income" account and an "Unbilled Charges" account and is based on accruing amounts as income at the time the related services are performed is in accordance with recognized and generally accepted accounting principles and clearly reflects Ebasco's income. He indicated that this method properly matched revenues with costs of producing such revenues and is particularly appropriate in this case because almost all of Ebasco's income is derived from the performance of services by its own personnel. He further testified that this method of accounting was widely used by companies engaged in rendering engineering and similar services, and that such method clearly reflected the income of Ebasco.

With respect to costs incurred in obtaining contracts, such as bid preparation, overhead, advertising, and other selling expenses, the witness considered them to be properly deducted in the year incurred as continuing costs of doing and developing business.[2] He explained that these costs should not properly be amortizable over the life of any particular contract since they were costs connected with new business development and were unrelated to performance of the contract.

The accounting method proposed by the Commissioner requires Ebasco to accrue as income the amounts included in the "Unearned Income" account and also requires the accrual, consistent with plaintiffs' accounting method, of amounts in the "Unbilled Charges" account. In the opinion of plaintiffs' expert, this method of accounting was not in accordance with generally accepted accounting principles and did not clearly reflect Ebasco's income. To him, the Commissioner's method was erroneous in that it required the inclusion in income of amounts billed but not yet earned on contracts in one accounting period without at the same time acknowledging the obligations and costs to be incurred by Ebasco in the future performance of such contractual commitments. He termed such method as "hybrid" in that while

[2] The witness distinguished such costs from commissions which in some instances may properly be amortized where they relate directly to the contract involved and thus reduce the amount realizable under such contract.

it recognized the accrual method with respect to unbilled charges which were earned but not yet billable, it had the effect of imposing a cash basis method as to the billed but unearned charges in the "Unearned Income" account.

Finally, the witness testified that if Ebasco were to use a method of accounting under which amounts in the "Unearned Income" account would be accrued as income and amounts in the "Unbilled Charges" account would *not* be accrued as income, such method would more clearly reflect the income of Ebasco than the method of accounting proposed by the Commissioner. He stated that, while such method was not technically in accordance with generally accepted accounting principles, it was a more logical and consistent approach to use in determining the income of Ebasco than the Commissioner's method.

The remaining issues involved in this case thus concern the accounting method employed by one of the plaintiffs, Ebasco Services (referred to below as "Ebasco"). Plaintiffs maintain that the method of deferral accounting employed by Ebasco (as described above) clearly reflects income and, therefore, is entirely proper for Federal income tax purposes. Alternatively, they contend that if Ebasco is required to accrue as income amounts in its deferred "Unearned Income" account, then in order clearly to reflect income, it should not accrue as income the amounts included in its "Unbilled Charges" account (also described above). With regard to the first of these contentions, the Government responds that the method of deferral accounting employed by Ebasco did not in fact clearly reflect income for tax purposes. As to the alternative contention, the Government agrees with Ebasco's original accounting treatment and insists that amounts in the "Unbilled Charges" account were properly accrued. The Government adds that acceptance of Ebasco's alternative contention would necessarily mean a change of accounting method for which plaintiffs admittedly have failed to obtain the consent of the Secretary or his delegate as required by section 446(e) of the 1954 Code.

These issues present but another facet in the continuing controversy over the proper timing for Federal income tax

purposes of various income and expense items incurred by an accrual basis taxpayer. Based on expert accounting testimony presented by Ebasco at trial, it can hardly be disputed that Ebasco's system for deferral of unearned income is in full accord with generally accepted accounting principles as that phrase is used in financial or commercial accounting. But such a showing alone is not determinative for income tax purposes. The taxpayer must also show that its method clearly reflects income for the purposes of the Internal Revenue Code. Thus, while generally accepted methods of accounting are of probative value and are treated with respect by Treas. Reg. § 1.446–1(a)(2), they are not necessarily synonymous with the proper tax accounting to be afforded an accrual item in a given situation. *See*, *Field Enterprises Inc.* v. *United States*, 172 Ct. Cl. 77, 84, 348 F. 2d 485, 489 (1965), *cert. denied*, 382 U.S. 1009 (1966); *Cincinnati, New Orleans and Texas Pacific Ry.* v. *United States*, 191 Ct. Cl. 572, 583, 424 F. 2d 563, 570 (1970); and *Simplified Tax Records, Inc.*, 41 T.C. 75, 81 (1963).

This variance is especially noticeable in cases where the taxpayer's accounting method results in the deferment of income. The taxpayer in such a situation is generally relying on well-known accounting principles which essentially focus on a conservative matching of income and expenses to the end that an item of income will be related to its correlative expenditure. Tax accounting, on the other hand, starts from the premise of a need for certainty in the collection of revenues and focuses on the concept of ability to pay. Thus, under this theory, where an item of income has been received even though as yet unearned, it should be subject to taxation because the taxpayer has in hand (or otherwise available) the funds necessary to pay the tax due. (*See*, Silk, *Advance Payments-Prepaid Income: Recent Developments: An Old Problem Put to Rest*, 30 N.Y.U. Inst. Fed Tax., 1651, 1652–1653 (1972)).

Putting such theoretical considerations aside for the moment, it may be helpful briefly to resummarize Ebasco's long-consistent method of accounting under which receipts are accrued and reported as income only at the time the engi-

neering and similar services which generate such receipts are rendered. In many cases, Ebasco's right to bill or receive payment arose prior to the annual accounting period in which the related services were to be performed. In other cases, the right to bill or receive payment arose subsequent to the annual accounting period in which the services were performed.

When under the terms of a contract Ebasco billed a client prior to the accounting period in which the related services were rendered, Ebasco debited the amount billed to accounts receivable and credited it to a balance sheet liability account called "Unearned Income." Subsequently, when the services were rendered, the income earned was debited to the "Unearned Income" account and credited to the income account "Service Revenues." The amounts recorded in the "Services Revenues" account were reported as income for both book and tax purposes. All of the amounts which were included in the "Unearned Income" account at the end of a taxable year were earned through the performance of services in the next succeeding year and were accrued and reported as income in such next succeeding taxable year for both book and tax purposes.

When services were performed in an annual accounting period and Ebasco was not entitled to bill a client for such services until a subsequent annual accounting period under the terms of a contract, Ebasco debited the amount attributable to such services to the balance sheet account "Unbilled Charges" and credited a like amount to "Service Revenues." The amount recorded in the "Service Revenues" account was reported as income for both book and tax purposes. Ebasco's cost of rendering the services which produced the amounts recorded in the "Unbilled Charges" account were deducted from gross income for that year for both book and tax purposes.

Thus, it can readily be seen that, under Ebasco's system, all amounts reported as income were determined with reference to the related services performed within the annual accounting period. The record clearly establishes that such system is a generally accepted accounting method for a busi-

ness such as Ebasco's. Does it clearly reflect income as required by section 446 of the Code? [3]

Defendant stoutly responds to that question in the negative. It relies heavily on the decisions of the Supreme Court in *American Automobile Ass'n* v. *United States*, 367 U.S. 687 (1961) and *Schlude* v. *Commissioner*, 372 U.S. 128 (1963), which cases defendant contends have firmly established the rule that, in the absence of a specific statutory exception, a taxpayer has no right to defer recognition of income received or accrued under a contract for the performance of services.

Counsel for Ebasco respond with equal vigor that Ebasco's accounting system does, in fact, clearly reflect income. To them, the Supreme Court in the above-cited decisions only held that the Commissioner of Internal Revenue did not abuse his discretion under section 446 by rejecting what the Court referred to as a "purely artificial" accounting method. Ebasco's counsel are astonished that defendant could in this case interpret *American Automobile* and *Schlude* as preventing any income deferral when, as recently as 1971, the Commissioner, in Rev. Proc. 71-21, 1971-2 C.B. 549 has held that taxpayers may defer the inclusion in income of payments received in one taxable year for services to be performed in the next succeeding year.

Although one can hardly speak with complete confidence in this troublesome and confusing area of tax law as affected by modern accounting methods, I think it fair to conclude that, on balance, Ebasco's position in this litigation is the reasonable one of the conflicting viewpoints.

The starting point, of course, must involve a close look at the trilogy of Supreme Court decisions dealing with the problem of income deferral. Those cases are *Automobile*

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[3] In pertinent part, section 446 reads:

"SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

"(a) GENERAL RULE.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) EXCEPTIONS.—If no method of accounting has been regularly used by the taxpayer, *or if the method used does not clearly reflect income*, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income." [Emphasis supplied.]

Club of Michigan v. *Commissioner*, 353 U.S. 180 (1957); *American Automobile Ass'n* v. *United States*, *supra;* and *Schlude* v. *Commissioner*, *supra.*

In *Michigan*, the Court sustained the action of the Commissioner of Internal Revenue in rejecting the taxpayer's method of deferral accounting pursuant to the authority of section 41 of the 1939 Code, the predecessor of 1954 Code section 446(b), *supra.* The taxpayer was engaged in performing various services to the automotive industry including the rendition of services to members of the club but only upon their specific request. Under its method of accounting, the club deferred taking into income the full amount of annual membership dues which the club required to be paid in advance, irrespective of whether the dues-paying member might call upon the club for any services during the 12-month period. Upon collection, these prepaid amounts were deposited in the club's regular bank account and used for general corporate purposes. In its books, the club entered these prepaid amounts into a liability account titled "Unearned Membership Dues," and thereafter for each of the 12 months of membership, one-twelfth of the amounts so paid was credited to an account called "Membership Income." In sustaining the Commissioner's rejection of this accounting method as not clearly reflecting income, the Court held:

> The pro rata allocation of the membership dues in monthly amounts is *purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member.* Section 41 vests the Commissioner with discretion to determine whether the petitioner's method of accounting clearly reflects income. We cannot say, in the circumstances here, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits * * * 353 U.S. 189. [Emphasis supplied.]

Four years later, the issue returned to the Court in the *American Automobile case.* While the facts were essentially similar to those in *Michigan*, it was contended in *American Automobile* that the earlier case did not control because the Court had before it at last a full record containing expert accounting testimony that the system used was in accord

with generally accepted accounting principles, that proof of membership service cost was detailed, and that the correlation between such cost and the period of time over which the dues were credited as income was shown and justified by proof of experience.

The Court, however, was unimpressed. Unable to perceive any significant difference between the methods of operation and accounting employed by the two automobile clubs, the Court held that, just as in *Michigan*, the American Automobile Association's system of accounting was "purely artificial" because "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year." 367 U.S. 691. The Court explained at 692:

> It may be true that to the accountant the actual incidence of cost in serving an individual member in exchange for his individual dues is inconsequential, or, from the viewpoint of commercial accounting, unessential to determination and disclosure of the overall finanical condition of the Association. That "irregularity," however, is highly relevant to the clarity of an accounting system which defers receipt, as earned income, of dues to a taxable period *in which no, some, or all of the services paid for by those dues may or may not be rendered.* The Code exacts its revenue from the individual member's dues which, no one disputes, constitute income. When their receipt as earned income is recognized ratably over two calendar years, *without regard to correspondingly fixed individual expense or performance justification*, but consistently with overall experience, their accounting doubtless presents a rather accurate image of the total financial structure, but fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner [Emphasis supplied.] [4]

The third of this trilogy of cases is *Schlude* v. *Commissioner*, *supra*, where the Court again rejected an attempt by an accrual basis taxpayer to defer prepaid amounts for future services. The taxpayers there operated a dance studio and offered dancing lessons under contracts which required the students to pay their tuition in advance with no right to refund, *i.e.*, the studio was entitled to receive the advance pay-

[4] Discussion of the Court's treatment of "other considerations" bearing upon its decision appears below.

ments under the contracts irrespective of whether the studio was ever called upon to render any teaching services.[5] At the end of each fiscal period, the total number of actually taught hours were multiplied by the applicable hourly rate. The resulting sum was then deducted from the deferred income account and reported as earned income on taxpayers' financial statements and income tax returns.

The Court held that the case was "squarely controlled by *American Automobile Association*," (372 U.S. 134) and sustained the Commissioner's rejection of Schlude's accounting method. Said the Court at 135–136:

> *The American Automobile Association* case rested upon an additional ground which is also controlling here. Relying upon *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, the Court rejected the taxpayer's system as *artificial since the advance payments related to services which were to be performed only upon customers' demands without relation to fixed dates in the future. The system employed here suffers from that very same vice*, for the studio sought to defer its cash receipts on the basis of contracts which did not provide for lessons on fixed dates after the taxable year, but left such dates to be arranged from time to time by the instructor and his student. Under the contracts, the student could arrange for some or all of the additional lessons or could simply allow their rights under the contracts to lapse. But even though the student did not demand the remaining lessons, the contracts permitted the studio to insist upon payment in accordance with the obligations undertaken and to retain whatever prepayments were made without restriction as to use and without obligation of refund. At the end of each period, while the number of lessons taught had been meticulously reflected, the studio was uncertain whether none, some or all of the remaining lessons would be rendered. *Clearly, services were rendered solely on demand in the fashion of the American Automobile Association and Automobile Club of Michigan cases.* [Emphasis supplied.]

It seems clear to me that, despite defendant's vigorous contention to the contrary, this trilogy of Supreme Court

[5] No dates for dancing lessons were fixed but simply left to a mutually agreeable arrangement between student and teacher. Significant amounts of income flowed from cancellations resulting in no performance of services.

decisions cannot be said to have established an unvarying rule of law that, absent a specific statutory exception, a taxpayer may never defer recognition of income received or accrued under a contract for the performance of future services, no matter whether such deferral clearly reflects income.

Defendant persuasively argues, however, that its interpretation of the cases is justified by the Court's additional ground for decision in both *American Automobile* and *Schlude*. In both cases, it is true, the Court's majority and minority opinions gave close consideration to the legislative history of sections 452 and 462 of the 1954 Code.[6] These sections contained the first explicit legislative sanctions of deferral of income (§ 452) and deduction of future estimated expenses (§ 462). In the next year, however, both sections were retroactively repealed. Ch. 143, 69 Stat. 134. To the majority in *American Automobile*, this repealer action constituted "clearly a mandate from the Congress that petitioner's system was not acceptable for tax purposes." 367 U.S. 695. The dissent, of course, viewed the legislative history in different perspective.[7]

To me, the dilemma and its likely solution, have been gracefully and accurately stated by the able and comprehensive opinion of the Fifth Circuit Court of Appeals in *Mooney Aircraft, Inc.* v. *United States*, 420 F. 2d 400, 408–409 (5th Cir., 1969) where the court observed:

> This alternative ground, based on legislative intent, would seem to dispose of the entire question: *all* deferrals and accruals are bad unless specifically authorized by Congress. But the Court was careful to discuss the legislative history as dictum and restricted its holding to a finding that the Commissioner did not abuse his

[6] 68A Stat. 152 and 168.

[7] For example, in his *Schulde* dissent, Mr. Justice Stewart observed at 372 U.S. 139–140:

"For the reasons I have elsewhere stated at some length, to rely on the repeal of §§ 452 and 462 as indicating congressional disapproval of accrual accounting principles is conspicuously to disregard clear evidence of legislative intent. The Secretary of the Treasury, who proposed the repeal of these sections, made explicitly clear that no inference of disapproval of accrual accounting principles was to be drawn from the repeal of the sections. So did the Senate Report. The repeal of these sections was occasioned solely by the fear of temporary revenue losses which would result from the taking of "double deductions" during the year of transition by taxpayers who had not previously maintained their books on an accrual basis." [Footnotes omitted.]

discretion in rejecting the *AAA*'s accounting system. It specifically refrained from overruling *Beacon* [218 F. 2d 697 (10th Cir. 1955) (deferral of prepaid subscriptions)] and *Schuessler* [280 F. 2d 722 (5th Cir. 1956) (accrual of expenses of 5-year service period)], distinguishing them on the ground that future performance was certain. *AAA*, *supra*, 367 U.S. at 692, n. 4, 81 S. Ct. 1727. It seems, then, that the Court is for the present taking a middle ground pending Congressional reform and clarification in this extremely confused area of the law: While the repeal of §§ 452 and 462 does not absolutely preclude deferrals and accruals, it indicates that the Commissioner should have very broad discretion to disallow such accounting techniques when there is any reasonable basis for his action.

The *Mooney Aircraft* approach was foreshadowed by the Seventh Circuit's decision in *Artnell Company* v. *Commissioner*, 400 F. 2d 981 (7th Cir., 1968). There, Chicago White Sox, Inc. had received and accrued in a deferred unearned income account amounts attributable to advance ticket sales and revenues for other services related to baseball games to be played thereafter during the 1962 season. Prior to such performance, however, Artnell acquired Chicago White Sox, Inc., liquidated it, and continued operation of the team. In the final short-year return filed as transferee by Artnell in behalf of White Sox, Inc., Artnell excluded the deferred unearned income previously received by White Sox. The Commissioner required such amounts to be accrued as income to White Sox on receipt, and the Tax Court sustained him. In reversing and remanding, the Seventh Circuit analyzed the Supreme Court's trilogy, *supra*, and said at 400 F. 2d 984–985:

> Has the Supreme Court left an opening for a decision that under the facts of a particular case, the extent and time of future performance are so certain, and related items properly accounted for with such clarity, that a system of accounting involving deferral of prepaid income is found clearly to reflect income, and the commissioner's rejection deemed an abuse of discretion? Or has it decided that the commissioner has complete and unreviewable discretion to reject deferral of prepaid income where Congress has made no provision? The tax

court apparently adopted the latter view, for it concluded "that the Supreme Court would reach the same decision regardless of the method used by the taxpayer for deferring prepaid income."

It is our best judgment that, although the policy of deferring, where possible, to congressional procedures in the tax field will cause the Supreme Court to accord the widest possible latitude to the commissioner's discretion, there must be situations where the deferral technique will so clearly reflect income that the Court will find an abuse of discretion if the commissioner rejects it.

Prior to 1955 the commissioner permitted accrual basis publishers to defer unearned income from magazine subscriptions if they had consistently done so in the past. He refused to allow others to adopt the method. In 1955 his refusal was held, by the tenth circuit, in *Beacon*, to be an abuse of discretion. In *Automobile Club of Michigan*, the Supreme Court distinguished *Beacon*, on its facts, because "performance of the subscription, in most instances, was, in part, necessarily deferred until the publication dates after the tax year." The Court, however, expressed no opinion upon the correctness of *Beacon*. In 1958, Congress dealt specifically with the *Beacon* problem. It is at least arguable that the deferral as income of prepaid admissions to events which will take place on a fixed schedule in a different taxable year is so similar to deferral of prepaid subscriptions that it would be an abuse of discretion to reject similar accounting treatment.

In any event the prepaid admission situation approaches much closer to certainty than the situations considered in *Automobile Club of Michigan*, *American Automobile Association*, or *Schlude*. [Footnotes omitted.]

Judicial reaction to *Artnell* has been mixed. Compare, for example, *Hagen Advertising Displays, Inc.* v. *Commissioner*, 407 F. 2d 1105 (6th Cir., 1969) and *Angelus Funeral Home* v. *Commissioner*, 407 F. 2d 210 (9th Cir., 1969), *cert. denied*, 396 U.S. 824, with *New Eng. Tank Indus. of N.H., Inc.* v. *Commissioner*, 413 F. 2d 1038 (1st Cir., 1969). *See*, also, *Petroleum Heat and Power Co.* v. *United States*, 186 Ct. Cl. 486, 492–495, 405 F. 2d 1300, 1302–1304 (1969). Defendant's reaction, of course, is simply that "*Artnell* was wrongly decided." Df's Br. p. 33.

Out of this mélange, one must choose a path. To use one of Justice Holmes' favorite expressions, I "can't help" but conclude that what Ebasco is pleased to call its "balanced and symmetrical" method of accounting does in fact clearly reflect its income. It achieves the desideratum of accurately matching costs and revenues by reason of the fact that the costs of earning such revenues are incurred at the time the services are performed. *See*, *Mooney Aircraft*, *supra*, 420 F. 2d at 403. Entirely unlike the factual situations before the Supreme Court in the automobile club and dance studio cases, Ebasco's contractual obligations were fixed and definite. In no sense was Ebasco's performance of services dependent solely upon the demand or request of its clientele.[8]

Based upon the foregoing considerations, it is necessary to conclude that Ebasco's method of accounting under which income is accrued as the related services are performed clearly reflects its income, and, accordingly, the Commissioner is not authorized by § 446(b) to impose another method of accounting. That this is true becomes particularly obvious when it is realized that the accounting method imposed upon Ebasco by the Commissioner is a classic example of a hybrid system combining elements of the accrual system with a cash system, a mixture generally viewed with disfavor. *See*, *Hackensack Water Co.* v. *United States*, 173 Ct. Cl. 606, 611, 352 F. 2d 807, 809 (1965). Thus, where Ebasco's billing precedes the rendition of its contracted-for services, the Commissioner proposes to tax as income amounts billed even though such amounts have not then been earned by performance. On the other hand, where the performance

[8] By way of illustrating the point, the overwhelming majority of the amounts carried in the "Unearned Income" account were paid to Ebasco pursuant to contracts for the performance of engineering services in the design and construction of electric generating plants. The construction of such a plant is, of course, a vast and complicated project involving many contractors and suppliers whose activities must be closely coordinated under rigid schedules. Therefore, as pointed out by Ebasco, there was never any question but that Ebasco had to perform its engineering services all of which were absolutely necessary to completion of the project. Many contracts contained fixed and specific dates for Ebasco's performance; others simply required Ebasco to proceed as "expeditiously as possible" or similar language. Thus, unlike the taxpayers in the Supreme Court decisions, Ebasco had a fixed obligation to perform its services without the uncertainty as to performance so prominent in those cases.

of services precedes billing, the Commissioner would tax amounts as income at the time the services are rendered even though, under such contracts, Ebasco has no present right to bill, or receive payment of such amounts. The inconsistency within the Commissioner's method is strident.

His method would appear to the ordinary mind to distort income instead of clearly reflecting it. Judging both by what he has rejected and what he would impose he has abused his discretion within the meaning of the authority cited, *Mooney Aircraft* and *Artnell.* Ebasco has demonstrated not only that its method of accounting is in accordance with generally accepted accounting principles but, in addition, clearly reflects its income, treating these issues to be discrete, as we must. Therefore, the amounts accrued in Ebasco's "Unearned Income" account are not taxable until the year in which Ebasco performs the services which earn that income.[9]

DAVIS, *Judge*, concurring: On the issue of original issue discount, I refer to my concurring opinion in *General Foods Corp.* v. *United States*, *ante* at 617. On the so-called "accounting" issue, I join the court in adopting (with some modifications) Trial Judge Fletcher's opinion.

CONCLUSION OF LAW

Upon the findings of fact and opinion, which are adopted by the court and made a part of the judgment herein, the court concludes as a matter of law that plaintiff is entitled to recover on the accounting issue and judgment is entered to that effect, with the determination of the amount of recovery to be reserved for further proceedings under Rule 131(c) in accordance with this opinion. Judgment is entered for defendant and the petitions are dismissed with respect to original issue discount.

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[9] This conclusion makes it unnecessary to pass on Ebasco's alternative contention, namely, that if required to accrue as income the amounts entered in its "Unearned Income" account, then in order clearly to reflect income Ebasco should not be required to accrue as income the amounts entered in its "Unbilled Charges" account.

Syllabus

528 F. 2d 1392

MERRITT-CHAPMAN & SCOTT CORPORATION v. THE UNITED STATES

[No. 89-64. Decided January 28, 1976]

ON PLAINTIFF'S AND DEFENDANT'S MOTIONS FOR SUMMARY JUDGMENT

Contracts; delays; constructive suspension of work; equitable adjustment; remand to administrative board.—This case is before the court for review of the fifth decision of the Corps of Engineers Board of Contract Appeals, having previously been before this court when the court held that the Government's failure to hand over the existing highway to plaintiff on the specified date resulted in effect in a partial suspension of work by the Government (from December 1, 1955 until at least April 14, 1956), that this delay was unreasonably long, and was actionable under the pre-1960 Suspension of Work clause (194 Ct. Cl. 461, 439 F. 2d 185 (1971)). While the court did not determine whether the contractor had in fact been harmed by the delay, the court instructed the board to allow both parties to present further evidence and to consider whether the unreasonable delay caused any additional expense or loss to the contractor, and, if so, in what amount. Thereafter, the board's decision now under review, in noting that "no new facts of evidence" had been presented, held that the contractor had not demonstrated that its operations "were adversely affected by the withholding of the road during that period." The board found that since plaintiff did not construct an underpass, which was an essential part of the contractor's plan to dispose of excavated material once the new highway was completed, until February 8, 1956, the Government could not be charged for the delay from December 1955 through February 1956; concluded that plaintiff's operations were at a standstill from the end of January to May 1956 because of abnormal rains during that period; and in essence held that the Government's suspension did not cause plaintiff any additional costs because even if the road had been transferred to plaintiff, the latter would have been delayed by other factors. It is *held* that the Government's constructive partial suspension was the proximate cause of increased costs entitling plaintiff to an equitable adjustment in contract price under the pre-1960 Suspension of Work clause, the board's finding to the contrary lacking support of substantial evidence. It is also *held* that remand to the board is appropriate for determination of quantum of damages. Plaintiff's motion for summary judgment is granted in part and denied in part, defendant's cross-motion is denied, proceedings are stayed for 6 months, and the case is remanded to the board to determine quan-

Syllabus

tum for the period of partial work suspension pursuant to Pub. L. 92–415 and Rule 149(b).

Contracts; Suspension of Work clause; pre-1960 clause; delay damages.

[1] The Suspension of Work clause necessitates an inquiry as to whether an unreasonable delay, occasioned by the Government, caused a contractor *any* additional expense or loss. Under the pre-1960 Suspension of Work clause a contractor is entitled to recover delay damages if the Government's delay is the proximate cause of the contractor's additional loss, even if some other occurrence might have hypothetically caused a like delay during that time.

United States ⇐ 73(21)

Contracts; Suspension of Work clause; 1960 clause; delay damages.

[2] Under the 1960 Suspension of Work clause, a contractor is entitled to recover delay damages only if the Government's delay is the sole proximate cause of the contractor's additional loss and only if the contractor was not delayed for any other reason during that period.

United States ⇐ 73(21)

Contracts; disputes; administrative findings; material fact established by record not found; duty of Court to make findings.

[3] Where the administrative board in a contract dispute has failed to make relevant findings of fact as to which the evidence is uncontroverted, this court can make its own findings.

United States ⇐ 73(15)

Contracts; suspension of work for convenience of Government; constructive suspension of work; equitable adjustment in contract price.

[4] Where the administrative board determined that plaintiff was not entitled to a price adjustment under the Suspension of Work Clause because it did not construct an underpass under a proposed new replacement highway which underpass was an essential part of plaintiff's plan to dispose of excavated material once the new highway was completed despite the fact that the Govrenment did not turn over to plaintiff the old highway as part of the dam construction site until approximately 4½ months after the date provided in the contract, since the underpass was available well before it was needed the lack thereof during the first 2 months was not a legal or superseding cause of the delay and does not negate the fact that defendant's delay in making the old highway site available caused plaintiff to incur additional expense, thus entitling it to relief under the language of the pre-1960 Suspension of Work clause. The board's opinion to the contrary being based on conjecture, is unacceptable under basic principles of proximate causation. Similarly, the abnormal rainfall during the latter 2-month period did not lift the suspension, and the Government's constructive suspension was the proximate cause of some additional costs to plaintiff.

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Plaintiff is entitled to recover compensation beyond the injury caused by delay when the Government's refusal of an express suspension of work during the rainy period also caused injury and cost in maintaining men and equipment at the site to no useful purpose.

United States ⟸ 73(20)

Contracts; suspension of work for convenience of Government; constructive suspension of work; equitable adjustment in contract price.

[5] A constructive suspension of work may result in demonstrable injury that an express suspension would avoid.

United States ⟸ 73(20)

Contracts; disputes; administrative remedies; damages; administrative determination of.

[6] Where the court has determined that the Government's constructive partial suspension of work was the proximate cause of increased costs to plaintiff entitling it to an equitable adjustment in contract price under the pre-1960 Suspension of Work clause, in view of the Supreme Court decisions in *United States* v. *Carlo Bianchi & Co.*, 373 U.S. (1963), and *United States* v. *Anthony Grace & Sons*, 384 U.S. 424 (1966), the court must remand the case to the administrative board for determination of quantum since despite the long pendency of this case mere delay is not a cause for deviation from required contract dispute procedure if the delay is not attributable directly to defendant's officers.

United States ⟸ 74(8)

Contracts; suspension of work for convenience of Government; constructive suspension of work.

[7] A constructive partial suspension of work, resulting from a partial withholding of the work site, is not any the less effective for lack of a formal suspension order, and relief should be granted as if an actual suspension order had been issued.

United States ⟸ 73(20)

Contracts; damages; measure of damages; constructive suspension of work; delays caused by Government.

[8] In determining the amount of the contractor's additional expense or loss by reason of the Government's constructive partial suspension of work, the administrative board on remand must recognize that the contractor was entitled to a partial suspension order and must compare the contractor's costs if the suspension of work order had been granted (the contractor would not have have had to work so much during the 4½-month period of delay) with the costs it incurred because thet suspension was not granted (forcing the contractor to keep its men and equipment at the work site and to incur other possible costs). In addition, to the extent a partial suspension would have relieved the contractor from work it attempted

Opinion of the Court

to perform during the abnormal rains and would have enabled it to perform instead in a more clement season, the extra rain-induced cost is compensable.

United States ⇐ 73(21)

Bruce Mayor for plaintiff. *Martin S. Michelson*, attorney of record.

Rex E. Lee, *Assistant Attorney General*, for defendant. *Susan M. Linden*, of counsel.

Before SKELTON, NICHOLS, and KUNZIG, *Judges*.

NICHOLS, *Judge*, delivered the opinion of the court:

This case comes before the court on defendant's request, filed April 18, 1975, for review by the court of Trial Judge Louis Spector's recommended decision of February 5, 1975. The case has a long and detailed history, having already occasioned five Corps of Engineers Board of Contract Appeals decisions, two recommended trial judge opinions, and one decision by this court, 194 Ct. Cl. 461, 439 F. 2d 185 (1971).

In an experiment sponsored by the American Bar Association and the Federal Judicial Center, and assented to by all parties concerned, the above named panel, sitting in Washington, D.C., heard oral argument delivered by counsel in New York, New York, using "Picturephone" facilities provided by the American Telephone & Telegraph Company. The facilities did their part and it is now up to us to do ours.

I.

The contract out of which this case arose was between Savin Construction Corporation, wholly-owned subsidiary and predecessor in interest of plaintiff, and the United States Government, acting through the Army Corps of Engineers, for the construction of the New Cumberland Locks and Dam on the Ohio River. Twin locks were to be built, involving the construction of 3 lock walls. An existing highway, Ohio State Highway No. 7, ran directly over the specified location of the middle lock wall for about three-fourths of its length. Defendant as part of its obligation to furnish the construc-

tion site, contracted with the State of Ohio to relocate the 2-mile section of State Highway No. 7. Defendant agreed to construct the subgrade for the relocated highway along a new alignment, following which the State Highway Department would have the permanent road placed. Once the new Highway No. 7 was opened to traffic, the State would turn the existing Highway No. 7 over to defendant so that plaintiff could excavate it in furtherance of the lock and dam project.

Accordingly, in March 1955, the defendant entered into two contracts for the construction of the subgrade, scheduled for completion as of October 1, 1955.

Plaintiff had been awarded the contract on October 24, 1955. The contract provided that plaintiff could not remove any part of existing State Highway No. 7 "until the relocated highway is opened to traffic, which will be about 1 December 1955." Further, plaintiff was instructed that disposal operations had to be completed by May 1, 1956. (This was due to a contract between defendant and Ohio Edison Company, permitting defendant to use adjacent Ohio Edison land to dispose of the excavated material as long as the disposal was terminated by May 1, 1956).

On November 4, 1955, plaintiff received Notice to Proceed and thereupon mobilized its men and equipment to initiate excavation. The construction of the cofferdam and pouring the concrete structures within the cofferdam area depended on the excavation being completed. Existing Highway No. 7 was not in fact made available to plaintiff on December 1, 1955, as the contract provided, but instead on April 14, 1956. The Government did not issue a formal suspension order suspending the work as it could and should have done under the Suspension of Work Clause and therefore plaintiff maintained its men and equipment in a state of readiness.

Plaintiff filed a formal claim with the Contracting Officer for the monetary consequences of defendant's failure to provide old Route 7 on time. The claim was denied and plaintiff appealed to the Corps of Engineers Board of Contract Appeals under the Disputes and the Suspension of Work Clauses.

It should be noted that the issue has always been a partial, not a complete suspension of work, and any reference to suspension hereinafter means this. Plaintiff described its damages allegedly resulting from the Government's partial suspension of work in failing to turn the site over in time as follows:

First. Increased excavation costs were incurred because the Government required the contractor to excavate in an area between the old and new Routes 7, a narrow, restricted confined and unproductive area. The V-shaped excavation, which narrowed as it deepened because of the slope requirements, acted as a trap for rain and ground water, aggravating excavation problems.

Second. Increased costs, such as idled equipment costs, were incurred because the Government did not issue a formal order suspending work, thus plaintiff was obligated to maintain its men and equipment in a state of readiness.

Third. Increased costs were incurred because of an overall delay to the project.

The Board, on December 10, 1963, determined that the Government did partially suspend the contractor's operations for 18 days and remanded the case to the contracting officer to consider quantum. Eng. BCA No. 2126 (1963). On plaintiff's motion for reconsideration, the Board found that the Government's partial suspension "unreasonably delayed the contractor to some extent between January and 14 April 1956." Eng. BCA No. 2126 (1964). A third opinion was issued denying the Government's request for reconsideration. Thereafter on March 14, 1968, the Board determined that plaintiff had not shown any damage. Eng. BCA No. 2675, 68-1 BCA ¶ 6935. Plaintiff appealed to this court and we issued a decision on March 19, 1971, remanding the case to the Board to determine "the existence or the amount of damages." 194 Ct. Cl. at 476, 439 F. 2d at 194. We specifically noted that "we do not make any determination on the substantive merits of the claim." 194 Ct. Cl. at 464, 439 F. 2d at 186. Thus our remand was broader than a remand only to determine quantum.

Several aspects of our prior decision bear repeating in light of the Board's fifth decision. We held that the Government's

failure to hand over the existing highway to plaintiff on the specified date resulted in effect in a partial suspension of work by the Government, actionable under the Suspension of Work Clause quoted *infra*. Plaintiff was denied access to a necessary part of the work site. The lack of a formal suspension order did not make the suspension any the less effective under the doctrine of Constructive Suspensions. Once it is determined that there was a partial suspension of work for the convenience of the Government, two separate questions emerge: 1st, did the suspension delay the work for an unreasonable length of time, and 2nd, if so, did this unreasonable delay cause additional expense or loss, and in what amount (quantum). We remanded the case because we thought that the Board "rolled all these questions into one," 194 Ct. Cl. at 474, 439 F. 2d at 192, however we did determine that the suspension lasted from December 1, 1955, until at least April 14, 1956, and this delay was unreasonably long. The Board was instructed to allow both parties to present further evidence and to consider whether the unreasonable delay caused any additional expense or loss to the contractor, and if so, in what amount. We did not determine whether the contractor had in fact been harmed by the delay but stated, "it is not out of place to say that prima facie it does seem that a delay of four-and-one-half months, in the circumstances thus far revealed by the record, would probably lead to some harm to this contractor. It may be that, for various reasons, plaintiff suffered no detriment at all from the withholding of Highway No. 7 for this long period, but, as of now, we do not see that conclusion as either clear or certain." 194 Ct. Cl. at 476, 431 F. 2d at 194. The unresolved issues then were whether the admittedly unreasonable delay harmed the contractor thus entitling him to relief under the Suspension of Work Clause, and if so, in what amount. The Board had to determine entitlement, a liability question, and then quantum, a damage question. It would seem that the "prima facie" appearance of harm would have to be overcome by new evidence if the Board were to find there was no harm.

The Board held a hearing on December 14, 1971, to allow both parties to present further evidence. Mr. Robert J. Jenks,

a key witness for plaintiff at the prior hearings, testified. Plaintiff also called Mr. James S. Clark, Assistant Secretary of Merritt-Chapman & Scott, to the stand in order to introduce a December 31, 1967, Financial Statement. The parties filed briefs presenting further arguments to the Board. Thereafter, the Board, in its fifth decision, noting that "no new facts of evidence" had been presented, held that the contractor had not demonstrated that his operations "were adversely affected by the withholding of the road during that period." The Board found that since plaintiff did not construct an underpass, which was an essential part of the contractor's plan to dispose of the excavated material once the new highway was completed until February 8, 1956, the Government could not be charged for the delay from December 1955 through February 1956. Further, the Board concluded that the contractor's operations were at a standstill from the end of January to May 1956 because of unusually wet weather during that period. The Board in essence held that the Government's suspension did not cause plaintiff any additional costs because even if the road had been transferred to plaintiff, the plaintiff would have been delayed by other factors. Eng. BCA No. 2675, 72-2 BCA ¶9620.

Plaintiff appealed again to this court and on February 2, 1975, Trial Judge Spector issued a recommended decision. The trial judge concluded that the Government's constructive partial suspension was the proximate cause of increased costs and that plaintiff was therefore entitled to an equitable adjustment in contract price under the Suspension of Work Clause. We agree and hold the contrary Board finding lacks support of substantial evidence. The trial judge went on to determine quantum because he felt that "justice requires that the court proceed with review of * * * [the Board's] conclusion [that plaintiff did not suffer any damage as a result of the suspension] particularly in this instance where the record has been fully developed and where there have been five prior decisions of the board * * *." Trial judge's report at 22. For the reasons discussed in Part III, we believe the trial judge is in error on this point and we remand the case to the Board for a determination of quantum. For clarity,

it should be noted that the Board decision is the one we have legally before us for review.

II.

The Suspension of Work Clause necessitates an inquiry as to whether an unreasonable delay, occasioned by the Government, caused a contractor any additional expense or loss. We stress the word "any". This is as we viewed it previously, initially not a quantum question but an issue of entitlement to relief under the contract clause. If it is answered affirmatively, then a quantum determination follows. The trial judge phrased the issue as one of proximate causation, for if the delay did not harm the contractor, he would not be entitled to recover.

The Suspension of Work Clause has an interesting history. It was first drafted during World War II as an outgrowth of agitation following the Supreme Court decision in *Rice* v. *United States*, 317 U.S. 61 (1942), and thereafter was used by the Army Corps of Engineers as a standard provision in fixed price construction contracts. The Court in *Rice* held that because of the "Changes," "Changed Conditions," and "Delays-Damages" clause in the contract, a contractor's exclusive remedy for a Government caused delay was a time extension. The Suspension of Work Clause provided that a time extension was not the only remedy available to a contractor, but that he could seek an equitable adjustment in contract price for any additional expense or loss caused by the Government's unreasonable delay not due to the contractor's own fault or negligence.

The Clause at issue reads in pertinent part as follows:

> * * * The Contracting Officer may order the Contractor to suspend all or any part of the work for such period of time as may be determined by him to be necessary or desirable for the convenience of the Government. Unless such suspension unreasonably delays the progress of the work and causes additional expense or loss to the Contractor, no increase in contract price will be allowed. In the case of suspension of all or any part of the work for an unreasonable length of time causing additional expense or loss, not due to the fault or negli-

> gence of the Contractor, the Contracting Officer shall make an equitable adjustment in the contract price and modify the contract accordingly. * * *

The Clause was used by some but not all military and civilian agencies throughout the 1940's and 1950's; however, it was not a mandatory Clause and until 1960, there was no prescribed uniform language. In 1950, a Government-wide effort to draft a standard Suspension of Work Clause failed as did a 1953 attempt by the Associated General Contractors to have such a Clause included in the Armed Services Procurement Regulations (ASPR). In 1955, the Navy recommended the adoption of a Suspension of Work Clause to the ASPR Committee. Although the Committee favored the idea, no action was taken and the matter was referred to a Government Task Force which had been established to unify Government procurement procedures. The Task Force established a Study Group which took testimony and solicited opinions from numerous Government agencies. In April 1958, the Study Group recommended a Suspension Clause for mandatory use throughout the Government. Clarke, *Government-Caused Delays In The Performance Of Federal Contracts: The Impact Of The Contract Clauses*, 22 Mil. L. Rev. 1, 27–37 (1963). After receipt of comments, some changes in wording were made and the Clause, entitled "Price Adjustment For Suspension, Delay Or Interruption of the Work" was published in the Federal Register as an "Additional Standardized Clause" to be inserted in Government contracts whenever "desired to provide for suspension of the work for the convenience of the Government and/or to provide for administrative relief for unreasonable periods of delay caused by the contracting officer in the administration of the contract." 25 Fed. Reg. 648 (1960). Thus the Clause was not mandatory, however, if an agency opted to use a Suspension of Work Clause it had to use the form as prescribed in the Federal Procurement Regulations, 41 C.F.R. § 1–7.602–1 (1961), ASPR 7–604–3 (Nov. 1961).

The 1960 Clause is similar to the Clause used in the Merritt-Chapman & Scott contract in that it allows an adjustment for any increase in the cost of performance of the contract "necessarily caused by the unreasonable period of

such * * * delay". However, it is more explicit in that it further provides that:

> No adjustment shall be made to the extent that performance by the Contractor would have been prevented by other causes even if the work had not been so suspended, delayed or interrupted.

(In 1968, the Clause became a required provision in all Government fixed price contracts. The name of the Clause was changed back to "Suspension of Work" Clause, however it remained in essentially the same form as the 1960 Clause. The 1968 version is used currently. ASPR 7-602.46; Federal Procurement Regulations 41 C.F.R. § 1-7.601-4).

The parties have not provided the court with a copy of the Study Group's recommendations or any pertinent ASPR Committee Minutes and we have not been able to locate a published text of the Study Group Final Report which might explain the reason the language of the Clause was changed in 1960. Therefore, we can only surmise as to the drafters' purpose in adding the provision quoted above to the 1960 Clause.

The pre-1960 Clause allowed a contractor to recover damages due to a Government caused delay not resulting from a contractor's own negligence or fault. It did not transfer all risks incident to delays not due to the fault or negligence of the contractor to the Government, as it has been interpreted to deny recovery for delays not attributable to the Government. *John A. Johnson & Sons, Inc.* v. *United States*, 180 Ct. Cl. 969 (1967); *Flippin Materials Co.* v. *United States*, 160 Ct. Cl. 357, 312 F. 2d 408 (1963); *Ozark Dam Constructors* v. *United States*, 153 Ct. Cl. 120, 288 F. 2d 913 (1961). A situation might arise, however, where the Government suspends operations for its own convenience while at the same time, the contractor is prevented from working by other causes. This can be analyzed in terms of concurrent causation. A contractor might be delayed by reason of two concurrent causes (that is, the Government's action or inaction and some other factor), each of which would have independently produced the delay during the same time period but neither of which supersedes the other as the dominant cause of the delay. The pre-1960 Suspension of Work Clause does

not, by its language, bar recovery because a contractor would have been prevented by other causes from performing its work when the Government's actions did in fact cause its damage. The Clause does not mention any consideration of concurrent causation in determining entitlement and this gap may have prompted the redrafting of the Clause in 1960.

The 1960 Clause seems specifically to preclude recovery if the contractor would have been equally delayed by other concurrent causes regardless of the Government's action or inaction. The Clause prevents any allocation of damages because it in effect determines that a contractor is not *entitled* to any recovery. It should be noted that the Clause does not weigh whether the Government's action is of less importance than the concurrent cause or whether the concurrent factor is a superseding action. Under the 1960 Clause, a contractor would be entitled to recovery only if the Government's delay is the sole proximate cause of the contractor's additional loss and only if the contractor would not have been delayed for any other reason during that period.

The pre-1960 Clause used here is not as specific as the 1960 version. The Board, in denying that plaintiff was entitled to an equitable adjustment because of the lack of an underpass and the severe rains, read a sentence into the contract which was not in the pre-1960 Clause. The question to be resolved is whether the Government's action or inaction caused the contractor additional expense or loss. The fact that something else *might have caused* the contractor to be delayed is not relevant in this inquiry. Only if it is determined that the contractor did not suffer any additional loss due to the Government's delay but that it was injured by some other superseding intervening cause, would plaintiff not be entitled to recovery. A contractor is entitled to recover, under the pre-1960 Clause if the Government's delay is the proximate cause of the contractor's additional loss, even if some other occurrence might have hypothetically caused a like delay during that time. A contractor would be denied recovery here only if it could be shown that the Government's delay did not cause the additional loss because some other factor caused the loss independent of the Government's actions.

Therefore, we must examine the factors the Board concluded caused delay to the plaintiff, to determine whether they, or the non-delivery of Highway No. 7, were legally the cause of the delay. We deal with uncontroverted facts, except where stated, and therefore can make our own findings. *S. S. Mullen, Inc.* v. *United States*, 182 Ct. Cl. 1, 389 F. 2d 390 (1968).

The first of these factors involved an underpass. The underpass was required because the jobsite was on one side of the proposed new Route 7 while the disposal area was on the other. Because it had been contemplated that traffic would be on the new Route 7 after December 1, 1955, and plaintiff was not permitted to cross Route 7 at grade, disposal was to be accomplished using an underpass. The underpass was not completed until February 8, 1956, and therefore the Board concluded that the first two months of the partial work suspension was caused by the absence of an underpass. However, there was no reason for plaintiff to complete the underpass any sooner. The new highway was not opened to traffic until April 14, 1956, at which time the underpass was complete. Even after that time, plaintiff was able to cross the new Route 7 at grade.

It cannot be said that the lack of an underpass was a legal or superseding cause of the delay during that two month period. Defendant, in its request for review, says the Government should be liable only if the contractor as a matter of fact would have progressed on schedule but for the suspension, but, if the contractor would have been delayed anyway, then there is no liability. This analysis would be more appropriate if we were confronted with the 1960 Clause. In response to plaintiff's contention that it would have taken only three to four days to build the underpass under pressure, defendant offers conflicting evidence. This is mere speculation and not relevant to the inquiry here. We do not know how long it would have taken plaintiff to build the underpass had it been under pressure to do so and the answer is not really knowable. We know that to some extent plaintiff was able to cross new Route 7 at grade even after it was opened. We do know that the underpass was ready well before it was needed. We do know that from December 1955

until April 1956 defendant failed to make the roadway available to plaintiff, whereas the possible effect of the underpass not being ready when new Route 7 came into use is the merest speculation. The lack of an underpass during the first two months does not negate the fact that defendant's delay caused plaintiff to incur additional expense, thus entitling it to relief under the language of the Suspension of Work Clause. The Board's contrary opinion is based on conjecture which is unacceptable under basic principles of proximate causation. The Board's conclusion that the first two months of the partial suspension was caused by the absence of an underpass, not by the Government, is incorrect as a matter of law. We hold that plaintiff is entitled to recovery for the two month period under the Suspension of Work Clause.

The second factor considered by the Board was the abnormal rainfall during the latter two month period of the partial suspension. Defendant shows the whole site was a hopeless quagmire. The Board reasoned that plaintiff would not have been able to work during that period regardless of the Government's delay. This conclusion suffers from the same defects in analysis as discussed above. To determine entitlement, we must consider only whether the Government's delay caused some additional loss or expense. The issue of how much is for quantum. The suspension constructively began on December 1, 1955, and continued until April 1956. The rains certainly did not lift the suspension, and instead enhanced the injury. The Government's constructive suspension was the proximate cause of some additional costs to plaintiff.

Though the Board's reasoning is not spelled out, we may take it to be that the contractor, given timely delivery of old Highway No. 7, would have been paralyzed still by heavy rains and resultant quagmire conditions from the end of January to the beginning of May 1956, with heavy loss to which the assuagement of a Suspension of Work claim would have been wholly unavailable. But this assumes a situation that did not occur in the real world, and the Board needed the 1960 version of the Clause to sustain it. In the real world plaintiff entered this rainy period already much behind, and needing to catch up, because of the partial constructive sus-

pension in effect since December 1. Yet because of receiving no express suspension, it had its men and equipment mobilized at the site to no useful purpose. Thus the rain magnified the injury. Plaintiff is entitled to recover compensation beyond the injury caused by delay when, as here, the refusal of an express suspension also caused injury and cost. A constructive suspension may thus result in demonstrable injury that an express suspension would avoid. The Board has failed to advert to this and again has applied the wrong concept of causation.

III.

Once it is determined that a contractor is entitled to recovery, the amount of the "additional expense or loss" must be resolved for an equitable adjustment. The trial judge concluded that the circumstances of this case required that the court determine quantum and proceeded to consider the issues involved in plaintiff's claim. The trial judge was, in our view, in error on this point. In view of the Supreme Court decisions in *United States* v. *Bianchi & Co.*, 373 U.S. 709 (1963), and *United States* v. *Anthony Grace & Sons*, 384 U.S. 424 (1966), we perforce and reluctantly remand the case to the Board for a determination of quantum. Plaintiff urges that this case is one contemplated by the Supreme Court in *Grace* when it stated that resort to administrative procedure would not be required "if it is shown by clear evidence that such procedure is 'inadequate or unavailable.'" 384 U.S. at 430. It is true that this case has been pending for a long time. However, we deem that the Board guided by our instructions is the only legal forum to determine quantum. The circumstances that caused the delays here were in a large part attributable to the absurd complexity of Wunderlich Act procedure itself. They cannot be attributed to any special sin or moral obliquity of the Board alone, not shared by the parties. Mere delay is not a cause for deviation from required procedure if it is not blameable directly to defendant's officers.

We did not determine liability or quantum in our prior decision although we did say that "prima facie it does seem that a delay of four-and-one-half months, in the circum-

stances thus far revealed by the record, would probably lead to some harm to this contractor." 194 Ct. Cl. at 476, 439 F. 2d at 194. We are now saying that the partial suspension of work, caused by the Government failing to hand over the road was an unreasonably long delay causing plaintiff some additional expense or loss. The contrary finding is not supported by substantial evidence. Plaintiff is entitled to relief under the Suspension of Work Clause and the Board must determine the appropriate amount of damages. It is unlikely that the Board can determine that plaintiff suffered no damages. The Board will conclude from Part II that we do not consider plaintiff's lack of an underpass to be relevant in determining damages. Plaintiff did not suffer any additional loss or expense by reason of the underpass. From December 1955 through January 1956, plaintiff was curtailed in its work only because of the Government's constructive partial suspension. Any additional expenses during that period due to delay must be charged to the Government.

The second two month period is somewhat more complicated. The Board compared the costs actually incurred by plaintiff with the costs plaintiff would have incurred had the road been relocated on time and concluded that plaintiff was not harmed by the Government's delay because, had the road been relocated on time, plaintiff would have been forced to work in the rain, or suspend operations on its own. This is not an appropriate standard for determining damages as it demonstrates a lack of understanding of the constructive suspension.

We have held that the contractor was entitled to a constructive partial suspension for the period of December through April. A partial suspension, resulting from a partial withholding of the work site is not any the less effective for lack of a formal suspension order. As early as 1948, the Corps of Engineers Board of Contract Appeals granted an equitable adjustment for delay under the Suspension of Work Clause where the Government had suspended work for its own convenience, although no formal order had been issued. The Board held that the issue was not what the Contracting Officer had done but what he should have done. *Guerin Bros.*, BCA 1551 (1948). A contracting officer may not deny relief

under the Suspension of Work Clause by the mere withholding of his order when the work has in fact been effectively suspended. A constructive suspension has the same effect and consequences as an actual suspension and relief should be granted as if an actual suspension order had been issued. *Urban Plumbing & Heating Co.* v. *United States*, 187 Ct. Cl. 15, 408 F. 2d 382 (1969), *cert. denied*, 398 U.S. 958 (1970); *Jefferson Const. Co.* v. *United States*, 177 Ct. Cl. 581, 368 F. 2d 247 (1966); *John A. Johnson & Sons*, *supra*. See also, 2 West's *Federal Practice Manual* § 1602 (1970). Thus, in determining quantum, we must assume that the work had been suspended by the Government from December through April. If the contractor had received a formal order, it would not have had to keep its men and equipment mobilized, at least as to that part of the work area subject to the partial suspension and it would not have had to work during the rainy period. In determining damages, the Board must recognize that the contractor was entitled to a partial suspension order and must compare the contractor's costs if the suspension had been granted (then it would not have had to work so much during that period) with those it incurred because the suspension was not granted (thus certainly forcing it to keep its men and equipment mobilized and possibly forcing it to incur greater excavation costs because of the slope problems).

It may be the rain works both ways. To the extent the plaintiff would have had to work even under partial suspension, extra cost occasioned by the rain must be excluded from the quantum of recovery. To the extent a partial suspension would have relieved plaintiff from work it attempted to perform in the rainy season, and would have enabled it to perform instead in a more clement season, the extra rain-induced cost is compensable.

In conclusion, we hold that plaintiff is entitled to an equitable adjustment under the Suspension of Work Clause for the period from December 1, 1955, through April 24, 1956. Accordingly, plaintiff's motion for summary judgment is granted in part and denied in part. Defendant's cross motion for summary judgment is denied. Further proceedings in this court are stayed for six months and we remand the case

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to the Board to determine the quantum of damages for the period of the partial work suspension, pursuant to Pub. L. 92–415, and the court's Rule 149(b). Plaintiff's counsel is instructed to advise the court of the status of proceedings at 90-day intervals, pursuant to Rule 149(f).

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529 F. 2d 1299

WALTER J. SAMPSON, BERNARD GREENBAUM, ABNER J. MESIROW, AND ARTHUR A. BOGEAUS, CO-PARTNERS, D/B/A SOUTHEASTERN INDUSTRIAL DEVELOPMENT DISTRICT, PLAINTIFFS, and THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, PLAINTIFF-INTERVENOR v. THE UNITED STATES

[No. 379–68. Decided January 28, 1976]

ON PLAINTIFF-INTERVENOR'S MOTION FOR REHEARING EN BANC

Mortgages; rights and liabilities of parties; Government lease; rehabilitation damages.—In 1946 the United States leased the Chimes Building, Syracuse, New York, from the then owner for 5 years with three 5-year renewal options, the lease obligating the Government upon termination to restore the premises to the original condition, reasonable wear and tear and damages by the elements excepted. Equitable Life Assurance Society (intervenor) had earlier acquired certain bonds and mortgages on the building, and in 1947 the mortgages were consolidated in a new mortgage, whereby Clause 20 assigned to Equitable any awards by the Government for taking by eminent domain the whole or any part of the premises. In 1952 plaintiff (SID) acquired the building. In need of additional funds SID borrowed from Equitable and on April 1, 1954 executed a bond and mortgage, the mortgage containing in Clause 20 an assignment to Equitable of all awards made theretofore and thereafter to be made to the present and all subsequent owners of the premises as security for the mortgage debt. Concurrently SID executed a new bond and mortgage in favor of Equitable, the mortgage consolidating prior mortgages of 1928, 1929, and 1947; the mortgage recited the recorded Government lease. On September 1, 1966 SID ratified and confirmed without change the 1954 consolidated mortgage which is presently in force. Plaintiff's suit originally sought rehabilitation damages upon termination of the Government lease. On June 28, 1974 the court entered an order assessing judgment against the United States in the amount of $292,574.26 (204 Ct. Cl. 920). Equitable intervened before trial claiming entitlement to the award as mortgagee of the building. On

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May 14, 1975 (207 Ct. Cl. 17), the presiding panel of the court dismissed Equitable's petition in intervention and entered judgment for SID, and Equitable has moved for rehearing en banc. SID has opposed the motion, claiming that the assignment to Equitable is limited to awards for eminent domain takings by the Government. In *reversing* the panel decision, the en banc court *holds* (1) that Equitable is allowed to intervene and that as mortgagee and assignee it is entitled to the award on its unpaid mortgage debt. Claim 20 of the 1954 consolidated mortgage assigned *all awards* made by anyone past, present and future, with respect to the mortgaged property, to Equitable as mortgagee and the assignment included the restoration award involved herein; (2) that Equitable did not waive its rights to the restoration award by not objecting to the agreement between SID and CIC (owner by assignment of the second mortgage which was in default in 1966) providing that CIC would receive any compensation award for rent as a result of a condemnation suit filed by the United States and that any restoration award for damages to the building (as distinguished from a claim for rent) was reserved to SID. Equitable was not a party to the agreement, was unaware of it, and subsequent correspondence between Equitable and SID shows that there was no waiver; (3) that Equitable did not waive its right under Clause 20 to the restoration award when it waived its right to the rent claim in the condemnation suit; (4) that Equitable is not barred by the doctrine of estoppel by deed by reason of certain recitals in the July 30, 1968 extension agreement between the then owners (not SID) and Equitable from asserting its claim to the restoration award under Clause 20 of the 1954 consolidated mortgage; (5) that SID's charge that Equitable slept on its rights is without merit; and (6) that the court will not intervene between the parties regarding payment of the fees of SID's attorney since the controversy is between private parties and one in which the Government is not involved. The decision of May 14, 1975 is *reversed* and the judgment in favor of SID is *set aside* and *vacated*, the plea of intervention is allowed, judgment is rendered granting Equitable's motion for summary judgment for the restoration award in the sum of $292,574.26 to be applied to its mortgage debt, SID's motion for summary judgment is denied, and SID's attorney's request for an attorney fee is denied.

Mortgages; construction and operation; rights and liabilities of parties.

[1] Where a mortgage consolidating prior mortgages assigned to the mortgagee *all awards* made theretofore and thereafter to be made to the present and all subsequent owners of the mortgaged premises as security for the mortgage debt, such assignment encompasses an award of rehabilitation damages as provided in the lease by the Government of the mortgaged premises, despite the fact that one of the prior mortgages was limited to awards for eminent domain takings by the Government.

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Estoppel; estoppel by deed.

[2] A recital in a deed of a material fact is binding and conclusive upon the parties, and those claiming under them in privies in blood, in estate, or in law. *Van Winkle* v. *Van Winkle*, 95 App. Div. 605, 89 N.Y.S. 26 (1904), *aff'd* 184 N.Y. 193, 77 N.E. 33 (1906). Where SID, the former owner of the mortgaged premises, was neither a party, heir, assignee nor successor to an extension agreement between the then-owner of the premises and the mortgagee, the agreement providing that "there are no offsets, set-offs, defenses or counter-claims against said Mortgage notes and mortgages * * * and that said mortgages, as consolidated and spread, are a first and valid lien upon the premises * * *," SID cannot invoke the defense of estoppel by deed in the present action in which SID and the mortgagee each claim the amount of the restoration-of-the-premises award. Furthermore, the quoted language is standard language used to prevent a mortgagor from claiming he has any defenses or offsets to the mortgage debt and is strictly for the protection of the mortgagee in exchange for its extending the time for payment of the debt.

Estoppel ⇐ 22(2)

Court of Claims jurisdiction; determination of attorney fee in controversy between private parties.

[3] Where the court has determined in an action brought by SID, the former owner of a mortgaged building, against the United States as lessee for rehabilitation damages, that the intervenor mortgagee E is entitled to the award, where SID agreed with its attorney that the latter was entitled to a fee of 40% of any recovery by SID, and where E has indicated willingness to pay SID's attorney an unstated reasonable fee, absent agreement between the parties of such fee this court will not intervene since this is a controversy between private parties in which the Government is not involved.

Courts ⇐ 448

John B. Carroll, attorney of record for plaintiffs. *Carroll, Carroll & Butz*, of counsel.

Hershel Shanks, attorney of record for plaintiff-intervenor. *Glassie, Pewett, Beebe & Shanks* and *James Bruce Davis*, of counsel.

Herbert Pittle, with whom was Assistant Attorney General *Wallace H. Johnson*, for defendant.

Before DAVIS, SKELTON, NICHOLAS, KUNZIG, and BENNETT. *Judges.*

Opinion of the Court

SKELTON, *Judge*, delivered the opinion of the court:

This case involves the claim of Walter J. Sampson, Bernard Greenbaum, Abner J. Mesirow, and Arthur A. Bogeaus, Co-partners, doing business under the name of Southeastern Industrial Development District (SID or plaintiff), as former owners of the Chimes Office Building in Syracuse, New York, to an award of $292,574.26 assessed against the United States, a former lessee of the building, as restoration damages upon the termination of the lease, as recommended by Trial Judge Spector and approved by an order of the court of June 28, 1974, in 204 Ct. Cl. 920, from which no appeal was taken. The Equitable Life Assurance Society of the United States (Equitable) intervened in the suit before trial claiming that it is entitled to the award as mortgagee of the building in accordance with the terms of its mortgage and the assignment contained therein, so that the proceeds of the award can be applied on its unpaid mortgage indebtedness. SID moved to dismiss the intervention by Equitable. A decision on the motion was postponed until the merits had been decided, and we are now required to decide whether to allow the motion to dismiss Equitable's intervention, and if denied, to decide who is entitled to the award. Both parties moved for summary judgment and oral argument was heard by a panel of the court, after which judgment was entered granting plaintiff's motion for summary judgment, denying that of Equitable and dismissing Equitable's petition in intervention. See 207 Ct. Cl. 17 (1975).

Following the above opinion, Equitable moved for a rehearing en banc which was granted, although SID opposed the motion. Additional briefs were filed and oral argument was heard by the en banc court. We reverse the decision of the panel and hold that Equitable is allowed to intervene and that as mortgagee and assignee it is entitled to the $292,574.26 award to be applied on its unpaid mortgage debt.

It appears that it will be necessary to again describe the basic facts upon which this controversy is based. The Chimes Building was built by the Hubb City Realty Corporation in 1928 at a reported cost of $1,420,000. That corporation executed a bond in the sum of $1,200,000 and a mortgage on the property to Metropolitan Life Insurance Company, recorded

August 31, 1929, in Liber 750 of Mortgages, page 641, County Clerk's Office, Onondaga County, New York. Another bond in the sum of $600,000 and mortgage was given on the building by James E. and Blanche O. Hefferman to the Syracuse Trust Company on March 20, 1928, which was recorded the same day in Liber 725 of Mortgages, page 129 of said county. In due time, Equitable acquired these bonds and mortgages and combined and consolidated them with later mortgages, as will be described below.

On July 5, 1946, the Onondaga Holding Corporation acquired the Chimes Building subject to the above mortgages. On December 3, 1946, the United States leased the building from the corporation for $250,000 per year for five years with three five-year renewal options.

After leasing the building to the Government, the Onondaga Holding Corporation desired to consolidate the 1928 and 1929 mortgages, and such prior mortgages were combined and consolidated with the new mortgage, dated December 26, 1947. This consolidation was advantageous to Onondaga because the debts were consolidated into one debt and the dates and amounts of payments were made more flexible. This 1947 mortgage is recorded in Book 1310, page 663, of Mortgages, Onondaga County, New York. It is important, because for the first time an assignment of awards was made to Equitable. This assignment appears in Clause 20 as follows:

> 20. That any and all awards heretofore and hereafter made to the present and all subsequent owners of the mortgaged premises by any governmental or other lawful authorities for taking by eminent domain the whole or any part of said premises or any easement therein, including any awards for any changes of grade of streets, are hereby assigned to the holder of said mortgage who is hereby authorized to collect and receive the proceeds of any such awards from such authorities and to give proper receipts and acquittances therefor, and to apply the same toward the payment of the amount owing on account of said bond and mortgage, notwithstanding the fact that the amount owing thereon may not then be due and payable; and the said party of the second part convenants and agrees, upon request, to make, execute and deliver any and all assignments and other instruments sufficient for the purpose of assign-

ing the aforesaid awards to the holder of said mortgage, free, clear and discharged of any and all encumbrances of any kind or nature whatsoever.

It will be noted that the assignment of awards in Clause 20 in this 1947 mortgage is limited to awards by the Government "*for taking by eminent domain the whole or any part of said premises* * * *." [Emphasis supplied.] It is important to note that this limitation of awards to those for Government taking by eminent domain was omitted and does not appear in later (1954) mortgages executed by SID to Equitable, where the assignment covers *all awards* made by *anyone*. As will be shown below, neither the Government nor takings by eminent domain are even mentioned in the assignments in the 1954 mortgages executed by SID and upon which the parties base their claims in this case.

On February 29, 1952, over four years after Onondaga executed the 1947 mortgage to Equitable, SID acquired the Chimes Building for $3,000,000. At that time SID needed additional funds and to take care of this need it borrowed $284,625 from Equitable and in connection therewith executed a bond and mortgage dated April 1, 1954, recorded in Book 1642, page 221, of Mortgages, Onondaga County, New York. This mortgage contains an assignment of *all awards* made or to be made to the present and all subsequent owners of the building to Equitable as security for the payment of the bond. This assignment, as pointed out above, was a revision and a rewriting of what appeared in Clause 20 of the 1947 mortgage quoted above. The revised Clause 20 (although it is not so numbered in this 1954 mortgage) provides as follows:

> Together also with any and all awards heretofore made and hereafter to be made to the present and all subsequent owners of said premises, including any award and awards for change of grade of any street affecting said premises, which said award and awards are hereby assigned to the mortgagee, who is hereby authorized and empowered to collect and receive such award and awards and to give proper receipts and acquittances therefor, and to appy [sic] the same toward the payment of the amount owing on this mortgage, notwithstanding the fact that the amount owing on this mortgage may not then be due and payable; and the mortgagor for himself,

his heirs and all subsequent owners of said premises, hereby covenants and agrees with the mortgagee and the successors and assigns of the mortgagee, upon request by the holder of this mortgage to make, execute and deliver any and all assignments and other instruments sufficient for the purpose of assigning said award and awards to the holder of this mortgage, free, clear and discharged of any encumbrances of any kind or nature whatsoever.

On the same day, April 1, 1954, SID executed a new bond and mortgage in favor of Equitable in which it was recited that Equitable was the owner and holder of the bonds and mortgages of 1928, 1929, and 1947 described above, together with SID's bond and mortgage of April 1, 1954, in the sum of $284,625, and on all of which there was owing to Equitable $1,650,000, all of which bonds and mortgages were combined and consolidated and spread over the property. This consolidated mortgage of April 1, 1954, is recorded in Book 1643, page 631, of Mortgages, Onondaga County, New York. It is important to note that this consolidated mortgage of April 1, 1954, recites that the premises are leased to the United States under a lease with Onondaga Corp. dated December 3, 1946, recorded in Liber 1311, page 249, Conveyances of Onondaga County, New York. The facts show that the Government had occupied the building since about December 3, 1946, and that it had made many alterations and changes in the building, such as removal of corridors, walls and partitions, lights, changes to terrazzo floors, elevator doors, marble and wood fixtures. The Government was obligated by the terms of its lease to restore the leased premises at the end of the lease to the condition they were in when the lease began, reasonable wear and tear and damages by the elements, excepted. It was obvious to any reasonable person that when the Government vacated the premises, it would have to either restore the premises at its own cost and expense or make a monetary award in lieu thereof.

Under these circumstances, SID executed the April 1, 1954, consolidated mortgage mentioned above in which it assigned to Equitable "*all awards* heretofore made or hereafter made to the present and all subsequent owners of the mortgaged premises as security for the mortgage debt." This assign-

ment is contained in Clause 20 of the April 1, 1954, Consolidated Mortgage as follows:

> 20. The party of the second part for themselves, their heirs, legal representatives, successors and assigns, does hereby assign to said party of the first part, its heirs, legal representatives, successors and assigns any and all awards heretofore made and hereafter to be made to the present and all subsequent owners of the mortgaged premises, including any award and awards for change of grade of any street affecting said mortgaged premises, and said party of the first part, its heirs, legal representatives, successors and assigns is hereby authorized and empowered to collect and receive such award and awards and to give proper receipts and acquittances therefor, and to apply the same toward the payment of the amount owing on said bond and mortgage, notwithstanding the fact that the amount owning on said bond and mortgage may not then be due and payable, and said party of the second part for themselves, their heirs, legal representatives, successors and assigns hereby covenants and agrees with said party of the first part, its heirs, legal representatives, successors and assigns upon request to make, execute and deliver any and all assignments and other instruments sufficient for the purpose of assigning said award and awards to the holder of said bond and mortgage, free, clear and discharged of any incumbrances of any kind or nature whatsoever.

It will be noted that this assignment is all inclusive and assigns "*all awards*" by anyone whomsoever, and that SID "covenants and agrees with the mortgagee [Equitable] to make, execute, and deliver any and all assignments and other instruments sufficient for the purpose of assigning said award and awards to the holder of said bond and mortgage, free, clear, and discharged of any incumbrances of any kind or nature whatsoever."

It would be difficult indeed to write an assignment more all inclusive, more comprehensive, and more unambiguous than the assignment of all awards made by SID to Equitable in the 1954 consolidated mortgage as security for Equitable's unpaid mortgage debt.

The plaintiff (SID) ratified and confirmed the Consolidated Mortgage of 1954, which is presently in force, on September 1, 1966, when it signed an extension agreement with

Equitable extending the time of payment of the mortgage debt. The extension agreement provided:

> * * * Nothing herein contained shall invalidate any of the security now held for said indebtedness or impair any of the conditions of the Bond and Mortgage except as herein specifically provided.

The extension agreement did not change the assignment of *all awards* in the mortgage. The foregoing provision had the effect of ratifying and confirming the assignment provisions in the mortgage.

Thus, we see that SID assigned all awards to Equitable twice in 1954 in the two mortgages it signed that year, and in 1966 ratified and confirmed the assignment provisions in the 1954 consolidated mortgage by the extension agreement.

SID claims in the instant suit that the assignment is limited to awards for eminent domain takings by the Government. There is no such limitation in the assignment in the 1954 consolidated mortgage. The 1947 mortgage did have such a limitation, but it was executed more than four years before SID owned the property and SID had nothing to do with that mortgage. Furthermore, the 1947 mortgage was replaced, combined, and consolidated by the 1954 mortgage signed by SID. It would appear that SID is trying to apply and enforce the limitation in the 1947 mortgage, which is no longer in force with regard to its claim here. This it cannot do. We hold that Clause 20 in the 1954 consolidated mortgage assigned *all awards* made by anyone past, present, and future, with respect to the mortgaged property, to Equitable as mortgagee as security for its mortgage debt, and that the assignment included the restoration award of $292,574.26 involved in the present suit. Equitable is entitled to recover such award so that it can be applied on the unpaid mortgage debt.

SID challenges Equitable's right to the award for other reasons which we will now consider.

The record shows that there was a second mortgage on the property to Irving Trust Company which was in default in 1966. City Investing Company (CIC) became the assignee of Irving Trust Company and commenced foreclosure proceedings against SID in a district court. In October 1967, CIC accepted a deed to the property from SID, which of

course was subject to Equitable's first mortgage, in lieu of foreclosure. CIC and SID agreed *between themselves* at the time that CIC would receive any compensation award for rent as a result of a condemnation suit filed by the United States to acquire the use of a part of the Chimes Building it had previously leased, for a further period ending November 30, 1967. *See United States* v. *Certain Space, Syracuse, New York*, 320 F. Supp. 491 (N.D. N.Y. 1969), *aff'd*, 435 F. 2d 872 (2d Cir. 1970), *cert. denied*, 402 U.S. 908 (1971). CIC and SID further agreed *between themselves* that any restoration award for damages to the building (as distinguished from a claim for rent) was reserved to SID. Equitable was not a party to this agreement and knew nothing about it until it received a letter from SID dated May 6, 1968, in which was enclosed a letter from CIC to SID dated September 14, 1967, describing the agreement. In its letter of May 6, 1968, SID asked Equitable to accede to the agreement between CIC and SID. Equitable refused, as shown by its letter of May 14, 1968, stating:

> As you may know, Equitable's mortgage on the captioned premises has not yet been paid off and, accordingly, Equitable does not wish at the present time to waive any rights which it may have under such mortgage.

It should be pointed out that as early as March 2, 1967, SID asked Equitable in a letter of that date to waive its rights to any restoration claim against the Government. Equitable refused in a letter to SID dated March 9, 1967, saying:

> In your letter of March 2 you have requested that the Equitable waive any claim to damages accruing during the term of the lease. I am not sure just what this term means. If it has reference to damage to the building which would incur costs for repairs or refinishing because of the government use, it would seem that the Equitable would be entitled to such reimbursement so that the building could be brought back as near as possible to its condition prior to the beginning date of the lease, reasonable wear and tear accepted [sic]. * * *

On May 20, 1968, SID again wrote to Equitable asking it to waive its rights under the mortgage and Equitable again refused in a letter to SID dated May 22, 1968.

The foregoing correspondence has been considered in detail because SID now claims that Equitable has waived its rights to the restoration award by not objecting to the agreement between CIC and SID. This argument is unpersuasive. Equitable was not a party to the agreement and did not even know about it until long after it had been made. The agreement is not binding on Equitable and it did not waive any rights it had under the mortgage by not objecting to something it did not know about. Furthermore, the foregoing correspondence between it and SID shows without question there was no waiver by Equitable.

SID also contends that Equitable waived its right to the restoration award by events that occurred at the trial of *United States* v. *Certain Space*, *supra*. We find this argument without merit. The facts in that case show that at the trial SID asserted three claims; namely, (1) a claim for rent for the space condemned; (2) the restoration of the premises claim; and (3) a "loss of equity" claim. During the proceedings, the court stated that the restoration claim could not be asserted in the condemnation case but would have to be pursued in the United States Court of Claims. The court further found that SID had no "loss of equity" claim. This left only the rent claim. Although Equitable could have asserted its right to the rent award under Clause 20 of its mortgage, it generously did not do so and waived its right to the rent claim. Equitable took the position that the condemnation award for the use of the building was the same as rent and that since its mortgage was not in default, it would not claim the award for rent.

SID contends that when Equitable waived its rent claim in the above case, it also waived its right to the restoration award. The court in that case rejected this argument of SID by saying:

> * * * [D]efendant Equitable has waived its right to lay claim to any part of the just compensation. However, if SID has some *residual rights* [*i.e.*, the "loss of equity" claim and the restoration claim] left under the assignment, [from SID to CIC] Equitable, in that case, asserts that it becomes entitled to them under the condemnation clause found in its first mortgage. [Emphasis supplied.] [320 F. Supp at 496.]

Again the court recognized that there was no waiver of the restoration claim by Equitable and that in fact it belonged to Equitable. The court said:

> Even if SID had some residual rights left under the assignment, Equitable, as noted earlier, asserts that it becomes entitled to them under the condemnation clause in its first mortgage. *This stands as a further bar to SID's claim.* [Footnote omitted] [Emphasis supplied] [320 F. Supp at 497]

The court referred to footnote 7 in its holding last above quoted, in which footnote Clause 20 of the 1954 consolidated mortgage is set forth in full. [320 F. Supp at 497.]

We hold that Equitable did not waive its right under Clause 20 of the mortgage to the restoration award when it waived its right to the rent claim.

SID argues that Equitable is estopped to claim the restoration award because on July 30, 1968, an extension agreement was executed between Salina Onondaga Company, a New York limited partnership, the then-owners of the building and Equitable wherein it was recited:

> WHEREAS, * * * there are no offsets, set-offs, defenses or counter-claims *against said Mortgage notes and mortgages* and the monies due thereunder *and that said mortgages*, as consolidated and spread, *are a first and valid lien upon the premises described therein;* * * * [Emphasis supplied.]

SID invokes the principle of estoppel by deed, citing *Van Winkle* v. *Van Winkle*, 95 App. Div. 605, 89 N.Y.S. 26 (1904), *aff'd*, 184 N.Y. 193, 77 N.E. 33 (1906). SID argues that the above quoted clause estops Equitable from claiming the restoration award in question. We do not agree, and find the argument without merit. The clause nowhere contains a statement directly or indirectly that Equitable has no claim to the award. We agree with the principles set forth in the *Van Winkle* case. It merely held that "* * * a recital in a deed of a material fact is binding and conclusive *upon the parties and those claiming under them* in privies in blood, in estate or in law." [Emphasis supplied.] [89 N.Y.S. at 28.] SID is neither a party, heir, assignee, nor successor to the extension agreement of July 30, 1968, and was not misled

thereby. The elements of estoppel are not present. The doctrine of estoppel by deed is not applicable, and cannot be invoked, by one (like SID) who is neither a party nor privy to the extension agreement from which the alleged estoppel by deed arises. 28 AM. JUR. 2d. *Estoppel and Waiver* §§ 8, 21, 114, 115; 31 C.J.S. *Estoppel* §§ 46, 47 at 351–52; and *Liberty Bank of Buffalo* v. *High Park Development Co.*, 134 Misc. 733, 236 N.Y.S. 194 (Sup. Ct. 1929), 227 App. Div. 647, *aff'd* 234 N.Y.S. 832 (Sup. Ct. 1929). The New York Court of Appeals has stated:

> Estoppels must be mutual; and none can avail themselves of them except parties or privies. [236 N.Y.S. at 201.]

See Walrath v. *Redfield*, 18 N.Y. 457, 460 (1858); *Finnegan* v. *McGuffog*, 203 N.Y. 342, 96 N.E. 1015 (1911). *See also, Litchfield* v. *Goodnow*, 123 U.S. 549, 551–52 (1887); and *White* v. *Croker*, 13 F. 2d 321, 324 (5th Cir. 1926), *cert. denied*, 273 U.S. 715.

In *Liberty Bank of Buffalo* v. *High Park Development Co.*, *supra*, the court held:

> Estoppel by deed or by record is operative only to the parties to the deed or record and their privies; *strangers to the deed or record are not bound by, nor can they invoke, the estoppel.* * * * [Many New York cases cited, including *Walrath* v. *Redfield*, cited above.] [Emphasis supplied.] [236 N.Y.S. at 201.]

Therefore, even if estoppel by deed is applicable here, which it is not as will be shown below, SID is in no position to assert it, because it is neither a party to the extension agreement nor one claiming under a party thereto and was in no way misled by the agreement.

In any event, the quoted language in the extension agreement is standard language used to prevent a mortgagor from claiming he has any defenses or offsets to the mortgage debt. It is strictly for the protection of the mortgagee in exchange for its extending the time for the payment of the debt. The debt is owed to the mortgagee and it makes no sense that the mortgagee or creditor would say that it had no offsets, etc., to a debt that is owed to it. The recited language makes sense only as a disclaimer by the mortgagor of any defenses it has

to the debt owed to the mortgagee. It will be remembered that the recited language in the extension agreement states that there are no offsets, etc., "*against* said mortgage notes and mortgages." (Emphasis supplied.) It would not be logical for a mortgagee (creditor), such as Equitable, to agree that it has no offsets, etc., *against* a debt owing to it. The debtor is the only one to which such a statement is applicable.

BLACK'S LAW DICTIONARY 1237 (4th ed. 1951, Rev.) defines "offset" as "a *contrary* claim or demand by which a given claim may be lessened or canceled." (Emphasis supplied.) WEBSTER'S NEW COLLEGIATE DICTIONARY defines "set-off" as "the discharge of a debt by setting *against* it a distinct claim *in favor of the debtor*." (Emphasis supplied.) See 20 AM. JUR. 2d. *Counterclaim, Recoupment & Setoff* § 2. The New York cases hold that "counterclaim" includes "set-offs." *See Seibert* v. *Dunn*, 216 N.Y. 237, 110 N.E. 447 (1915); *Otto* v. *Lincoln Savings Bank of Brooklyn*, 51 N.Y.S. 2d. 561, 268 App. Div. 400 (1944), *aff'd*, 294 N.Y. 798, 62 N.E. 2d 236 (1945); and 20 AM. JUR. 2d *Counterclaim, Recoupment & Setoff* § 3. It has been held that the "sole purpose of a counterclaim is to defeat or diminish the demand of a plaintiff" (in this case the demand of Equitable, the assignees and mortgagee). *See Schultz* v. *Wilson*, 59 Misc. 2d 14, 297 N.Y.S. 2d 478, 480 (1969); *White* v. *Bevilacqua*, 273 N.Y. 282, 7 N.E. 2d 134 (1937).

The above cases show that the terms recited in the extension agreement refer to situations wherein *a debtor* asserts a claim *against a creditor* in the nature of an offset to reduce the debt. It is obvious that only the debtor or mortgagor can have an "offset, set-off counterclaim or defense" against the mortgage debt. Accordingly, the recitation in question in the extension agreement can only be a representation by the debtor or mortgagor and not by the creditor or mortgagee (Equitable).

The estoppel by deed theory of SID is further negated by other provisions of the extension agreement, such as:

> (e) Mortgagor to pay for * * * such fees as a title insurance company will charge to endorse the existing title policy *to insure the continued validity and priority of the mortgagee's interest in said premises.*
>
> * * * * *

(i) *That the aforesaid mortgage notes and mortgages* are a valid subsisting obligation upon the premises described in such mortgages, and as such, *are a first lien, as consolidated, upon the premises described therein.*

(j) Except as herein modified and extended, *the terms, covenants and conditions of such mortgages as consolidated, shall remain in full force and effect.* [Emphasis supplied.]

Nothing in the consolidated mortgage was modified or extended by the agreement, except the amounts of the payments on the note and the dates when such payments were to be made. Clause 20 of the mortgage was not mentioned nor changed in any way. Actually, the whole tenor of the agreement was to continue the mortgage in full force and effect as to all its terms and provisions, which, of course, included the assignment in Clause 20.

We hold that Equitable is not barred by the doctrine of estoppel by deed by reason of the recitals in the July 30, 1968, extension agreement from asserting its claim to the restoration award under Clause 20 of its 1954 consolidated mortgage.

As a matter of fact, it is possible that Equitable could have invoked the doctrine of estoppel by deed against SID, because SID unequivocally assigned *all awards* made with respect to the leased premises by anyone to Equitable in two different 1954 mortgages and ratified and confirmed the consolidated 1954 mortgage in an extension agreement of 1966, all as shown above, all of which was relied on by Equitable. Now SID is attempting to contradict the provisions of such mortgages and extension agreement. However, Equitable has not urged this doctrine and we are not required to decide it and do not do so.

SID says that Equitable is not entitled to the restoration award because of our decision in *Beaconwear Clothing Co.* v. *United States*, 174 Ct. Cl. 40, 355 F. 2d 583 (1966). We do not agree. That case is clearly distinguishable from the instant case and is inapposite to our case. In that case, Beaconwear had assigned its claim against the Government to a bank to secure the loans made to finance performance of Beaconwear's contract with the Government. The entire debt was repaid to the bank. Nevertheless, the bank sought to

obtain a judgment on the basis of the assignment so as to obtain funds for an unpaid subcontractor and thereby avoid a counterclaim of the Government against Beaconwear. We ruled against the bank because the debt to the bank had been discharged by payment and it no longer had any financial interest in the obligation. SID argues here that Equitable is in the same position as the bank in *Beaconwear*. We do not agree. In *Beaconwear* the bank had been paid in full and had no further interest in the litigation. In contrast, in our case, Equitable's debt has not been paid and it has every right to assert its claim to the restoration award under its assignment and mortgage. If Equitable's debt and mortgage had been paid in full, it would be in the same position as the bank in *Beaconwear* and would have no right to assert a claim to the restoration award, but this is not the situation because Equitable's debt and mortgage have not been paid. Consequently, as stated above, the *Beaconwear* case is not controlling here.

SID argues further that when Equitable executed the extension agreement of July 30, 1968, with the then owners of the property without the consent of SID, the agreement had the effect of releasing SID from any obligation with respect to the debt and mortgage in favor of Equitable. We do not agree. SID was never liable personally on the bond or mortgage in favor of Equitable. By this argument, SID attempts to invoke the principle that when a creditor extends the date of payment of a note without the consent of the surety or the person secondarily liable, the surety or the person secondarily liable is discharged from all liability on the note. The defect in this argument is that SID was never personally liable directly or secondarily to Equitable on the note. Consequently, when Equitable entered into the extension agreement of July 30, 1968, with the then owners of the property, it had no effect whatever on Equitable's right to claim the restoration award under Clause 20 of its 1954 consolidated mortgage.

SID claims that Equitable has slept on its rights and is not entitled to receive the restoration award in this case because SID filed the suit for the award and won the award and is entitled to it. Again, we find this position of SID with-

out merit. The 1954 consolidated mortgage signed by SID provided in pertinent part as follows:

> 13a. That a substantial portion of the mortgaged premises are leased to the United States of America * * * and [SID] does hereby agree:
>
> (a) To faithfully abide by, perform and discharge each and every obligation, covenant and agreement of the lease by lessor to be performed; *at the sole cost and expense of the party of the second part*, [SID] to enforce or secure the performance of each and every obligation, covenant, condition and agreement of the lease by the lessee to be performed; * * *.
>
> (b) *At the party of the second part's* [SID's] *sole cost and expense* to appear in and defend any action or proceeding arising under, growing out of or in any manner connected with the lease or the obligations, duties or liabilities of lessor and lessee thereunder, *and to pay all costs and expenses of the party of the first part*, [*Equitable*] *including attorney's fees* in a reasonable sum in any such action or proceeding in which the party of the first part [SID] may appear. [Emphasis supplied.]

As shown above, SID was obligated at its sole cost and expense to enforce all covenants and obligations of the lessee [the Government] specified in the lease. One of such covenants and obligations of the lessee, as provided in paragraph 8 of the lease, was to "restore the premises to the same condition as that existing at the time of entering upon the same under this lease, reasonable and ordinary wear and tear and damages by the elements or by circumstances over which the Government has no control, excepted" at the end of the lease.

Thus, we see by the specific terms of the mortgage, SID was obligated to see that the Government restored the premises at the end of the lease. In filing the suit against the Government for the restoration award, SID did what it was required to do under the provisions of the mortgage. In any event, Equitable intervened in the suit before trial. Therefore, there is no merit to SID's argument that Equitable slept on its rights.

The attorney for SID alleges that he has an agreement with SID that would allow him an attorney fee of 40 percent of any recovery by SID in this case, and that the court should

Dissenting Opinion by Judge Nichols

allow him an attorney fee in this amount. Of course, under our judgment there is no recovery by SID and the 40 percent contract is of no help to its attorney. His claim for an attorney fee is not against the United States but is a contingent claim against an award to SID if there had been such award. The attorney has no definite agreement with Equitable as to an attorney fee. However, despite the fact that his efforts have been adverse to Equitable's claim in this case, Equitable has stated in its brief and through its attorney at oral argument that it is willing to pay SID's attorney a reasonable attorney fee, but the amount is not stated. We suspended proceedings in the case until the parties agreed upon such attorney fee. However, a reasonable time has elapsed since such suspension was entered and the court has not been furnished with an agreement as to the attorney fee, and, accordingly, it appears that the suspension should be lifted so that this judgment may be rendered and the case disposed of. Under these circumstances, the parties and SID's attorney are left to settle the attorney fee question themselves, because it is a controversy between private parties in which the Government is not involved and this court will not intervene.

The decision of the panel of May 14, 1975, is reversed, and the judgment heretofore entered in favor of SID is hereby set aside and vacated. SID's motion to dismiss Equitable's plea in intervention is denied and the intervention is allowed. The suspension of the case pending an agreement of the parties with respect to a reasonable attorney fee to be paid by Equitable to SID's attorney is lifted, and judgment is rendered granting Equitable's motion for summary judgment for the restoration award in the sum of $292,574.26 to be applied on its mortgage debt. The motion for summary judgment of SID is denied; and the request of SID's attorney for an attorney fee is also denied. Plaintiff's counsel is directed to return to the clerk of this court the transcript of judgment furnished him on July 2, 1974.

NICHOLS, *Judge*, dissenting:

I respectfully dissent and would still dismiss the intervention as the panel would have done.

This court's *en banc* opinion follows the time honored judicial rule of stating the issues so a reader would conclude that no qualified lawyer outside of St. Elizabeth's would come in good faith to a result contrary to the court's. Equitable's able counsel found in the panel opinion in this case a statement that Equitable had waived its claim against this court's award under Clause 20, a view he ostentatiously refuted by producing documents which showed Equitable had been asked to do this and had refused. Unless I speak out in dissent, no one will know that the panel found the so-called Clause 20 not to be applicable to the case at all, being at best (from Equitable's point of view) ambiguous and construed otherwise than Equitable's present contention by the prior conduct of all the parties, including Equitable. The offending statement, if not the *mot juste*, plainly referred to this and it required a totally unsympathetic reader not to perceive this was what the panel had in mind when it spoke of a waiver.

See the majority opinion for the text of the Clause. Equitable's counsel freely conceded, both in brief and oral argument, that its sweep was not as broad as its literal language. The court, however, says it would be difficult to write an "assignment more all inclusive * * *" and in a sense that is true. It is so all inclusive it must be narrowed by construction: as written it would apply to an "award" to Mr. Sampson as Jaycee of the Year. (A claim by Equitable to an award of that character would have the support of "legislative history" since the 1947 Clause 20 applied only to awards "by any Governmental or other lawful authority", while the 1954 Clause, here for interpretation, is not so limited.) On the other hand, I can easily conceive of broadening the Clause by making it apply to claims as well as to awards: the consequences of this omission I discuss below. Obviously its interpretation must be intuitive, not literal. It is in fact, if intended to be clear, most ineptly drafted, well below the normal standards of real estate conveyancers.

Equitable freely concedes it applies only to awards to an owner in his capacity of owner or with respect to his ownership. Since the Sampson group (SID) had no ownership interest in the mortgaged premises whatever, when they first sued in this court, or thereafter at any time to date, it would seem some analysis is wanting, as to why the award we have

made is an award to an owner in his capacity as owner or with respect to his ownership. It is an award of damages for breach of a Government contract. Such a problem would not have arisen with the original 1947 form of the Clause, as quoted by the court, since condemnation awards are made *in rem* to any and all owners, as their interests may appear, and no others. Awards for changes in street grade are generally treated the same way. The broadening in the 1954 mortgage raises the problem.

SID and CIC manifestly dealt with the claim that ultimately germinated in our award, as if it did not pertain to ownership. While CIC became owner, and reshuffled accordingly the bundle of rights constituting ownership, SID took the claim which with $10,000, was all it salvaged from its losing investment. Equitable was asked to waive its right, if any, against this claim, and it refused to do so. This the panel did not know until the motion for rehearing. However, the fact falls much short of denial or refutation of SID and CIC's obvious belief that the claim did not pertain to ownership. Indeed, refutation of this was not possible. There was no expression of opposition or alarm by Equitable at the claim falling into the hands of a non-owner for prosecution. SID might have failed to prosecute the claim vigorously for lack of means, or might have set it off against debts it or its partners owed the Government. Equitable's conduct in refusing an express waiver is best accounted for, I think, by the hypothesis that they didn't know what they had, but whatever it was, they were not going to give it away. I do not read its refusals as plain notice it intended to deprive SID of any success it might gain. It was the intervention in the suit that gave that notice and by then SID had passed the point of no return.

As the panel opinion said:

> * * * If the former owner and the new one agree that the former owner, not the new one, shall receive any particular award, this shows an understanding by them that the award is not made with respect to ownership, but is a personal asset of the prior owner. Such an understanding would not bind the mortgagee if he was not aware of it, but if he was aware, and made no protest, this would tend to show that his understanding of

> the meaning of Clause 20 was the same as that of both the new and the old mortgagors. Here the mortgagee not only made no protest, but was a party to a trilateral series of transactions, of which the retention of the restoration claim by the SID group was an integral part. Thus we think the practical construction of all the parties supports [our conclusion].

The opinion elsewhere says that "Equitable tacitly acquiesced in CIC's agreements with SID in their entirety until March 12, 1971 * * *".

Equitable now says, that it was SID's duty to prosecute the claim, at its sole cost and expense, for the sole benefit of Equitable, with no improvement to SID's equity to anticipate, for it had none, or other benefit of any kind, except perhaps, the satisfaction of duty disinterestedly performed. Not, please note, that it was SID's duty to let Equitable use its name to prosecute the claim. Just the opposite. If, however, Equitable in 1967–68 genuinely believed the above statement of its rights was accurate, it is impossible to believe it would have done nothing effective to protect and further them against obvious jeopardy. Though this is the bizarre result, (unless and to the extent that Equitable pays a counsel fee for the trial in this court, without visible legal compulsion so to do) antecedently considered, the unlikelihood of SID prosecuting the claim gratuitously for Equitable would have been large. The latter's bare intervention in the suit, leaving prosecution wholly to SID, was not just the minimum, it was far below the least that might have been expected if it really believed the award would be its own. Until intervention, Equitable said and did nothing to refute the obvious and well founded belief of SID and CIC that the claim was not by an owner with respect to his ownership, and therefore not under Clause 20.

It is well established law in this court that the conduct of the parties to a contract may not only interpret an ambiguous clause, but may even overcome plain language. *Gresham & Co.* v. *United States*, 200 Ct. Cl. 97, 470 F. 2d 542 (1972), and cases cited. By their conduct SID and CIC displayed their view that the claim against the Government, prosecuted in this suit, was outside Clause 20. It is now clear there existed no express understanding, with Equitable as

a party, to that effect, but such an express understanding is not required when the issue is contract interpretation. Equitable knew the others had so agreed.

Equitable of course was entitled to have the Government waste made good, but this was apparently done with new capital long before the claim herein was decided.

The court refers to clauses obliging SID to enforce the Government's lease obligations and to "appear in and *defend*" (emphasis supplied) any litigation relating to the lease. I question what effect this Clause had after SID ceased to be an owner. The parties seem to have hitherto supposed that Clause 20 was the only one that might have remained alive as to SID after that date. The confining of the Clause to defense of suits is significant.

The final curious thing about Clause 20 is that though it assigns awards, it does not assign claims. It looks as if textually SID had a perfect right to deal with the claim as its own, so long as it was just a claim, to decide not to prosecute it, or to set it off against any debt it might owe the Government. (Equitable's assertion of a right to gratuitous prosecution of the claim by SID rewrites Clause 20.) If SID had received a payment from the Government for restoration damages, without suit, it does not look as if Equitable would have had any right to it under Clause 20. Similarly if, after suit was brought, the Government made a settlement payment on condition of dismissal with prejudice. If the word "award" in Clause 20 means, besides condemnation awards only others of an *in rem* nature, the apparent absurdity is accounted for. The taker initiates and controls the action and an award to an owner in some amount is assured. The claimant doesn't have to prosecute, the only problem, normally, for the condemnee being to go in and establish he is entitled to all or part of the deposit in the court registry, as owner or one of the owners. The draftsman, in dropping out his reference to condemnations, may have been intentionally vague as to what else was covered, whether, specifically, *in personam* claims the claimant has full control of and must prosecute throughout if they are to ripen into awards.

At any rate, if I were a mortgagee and desired an assignment that was "all inclusive, * * * comprehensive * * *

and * * * unambiguous" in the court's words, I would be far from satisfied with the Clause here under review. I believe the interpretation given by the majority cannot be sustained by the language itself, or the surrounding circumstances, or the conduct of the parties.

The other arguments in the majority opinion I am not disposed to contest as they seek to demolish alternative points in the panel opinion that were relatively weaker than the interpretation point I considered and now consider crucial. It is a good idea both in advocacy and adjudication, to develop your strong point and leave unstated your alternative weaker ones; otherwise you can expect your strong point to be ignored, while pages are devoted to refuting the others.

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534 F. 2d 244

CARRIER CORPORATION v. THE UNITED STATES

[No. 267-74. Decided January 28, 1976, as amended pursuant to Order dated March 26, 1976]

ON DEFENDANT'S MOTION FOR PARTIAL SUMMARY JUDGMENT

Patents; infringement; use by or for the Government; Government authorization or consent to infringement; service contract.—Plaintiff, the owner of patents relating to certain features of refuse compactors and containers, seeks compensation under 28 U.S.C. § 1498(a) for the use without license of its patents. Although other contracts are involved in this case, this opinion on defendant's motion for partial summary judgment is addressed solely to alleged infringement of patent No. 3,144,149 (relating to detachable refuse containers) during performance of a service contract awarded by the Department of the Air Force to Associated Refuse and Compaction Services, Inc. for collection and removal of refuse at Andrews Air Force Base. It is *held* that since the use of equipment covered by the patent was not required by the contract specifications or written instruction of the contracting officer, the Government has not authorized or consented to any infringement of plaintiff's patent; and that the service Associated Refuse performed at said Base is not the type of activity that Congress, by enacting Sec. 1498(a), intended to cloak with immunity from injunction. If there was any use of plaintiff's invention, such use was by the contractor and not by the Government. Plaintiff is not entitled to recover from the Government for any use under the Andrews contract of patent No. 3,144,149. Defendant's motion is granted

Syllabus

and plaintiff's petition is dismissed to the extent that it seeks compensation respecting the Andrews contract.

Court of Claims jurisdiction; patents; use by or for the Government.

[1] In order to have jurisdiction of an action brought under 28 U.S.C. § 1498(a), the Court of Claims must be satisfied that the complained of use of the patented invention is a use by or for the Government within the meaning of said section.

Courts ⇐ 449(3)

Patents; infringement; use by or for the Government; Government authorization or consent to infringement.

[2] That portion of 28 U.S.C. § 1498(a) providing that the Government authorizes and consents to infringement of any patent "embodied in the structure or composition of any article the delivery of which is accepted by the Government" is applicable to hardware and other goods procured by and delivered to the Government for its own use, generally through supply contracts. The quoted portion of the clause is inapposite to a contract for services.

Courts ⇐ 449(3)

Patents; infringement; use by or for the Government; Government authorization or consent to infringement.

[3] Where neither the contract specification nor any specific written instructions from the contracting officer required the contractor to use a particular type of refuse handling equipment in performance of its service contract for collection and removal of refuse from a Government installation, use by the contractor of plaintiff's patented invention in performance of the contract does not constitute a use authorized or consented to by the Government within the meaning of 28 U.S.C. § 1498(a). *Cross-Reynolds Co.* v. *Perini-Leavell-Jones-Vinell*, 399 F. 2d 913 (5th Cir. 1968), *cert denied*, 393 U.S. 1050 (1969); *distinguished* and not followed.

Courts ⇐ 449(3)

Patents; infringement; use by or for the Government; Government authorization or consent to infringement.

[4] The fact that a service contract for collection and removal of refuse provided that all equipment for use in accordance therewith would become operative only after inspection and acceptance by the contracting officer, does not provide sufficient basis for finding that the Government authorized or consented to infringement within the meaning of 28 U.S.C. § 1498(a) of plaintiff's patent relating to certain features of refuse compactors and containers. The contract provision was intended merely to insure that the containers were steel refuse containers of specified size and that the compactors were capable of compacting refuse.

Courts ⇐ 449(3)

Statutes; construction and operation; legislative intent; generally.

[5] The language of a statute itself is the best indication of the intent of Congress. Since Sec. 1498(a) of Title 28 expressly pro-

vides that any use of a patented invention for the Government must be authorized or consented to, it is plain that the Government can limit its authorization and consent as it did in this instance.

Courts ⇐ 449(3)
Statutes ⇐ 188

Patents; infringement; use by or for the Government.

[6] That equipment is constructed by a contractor for use in performance of a Government contract, and is so used, does not alone constitute "use" for the Government within the meaning of 28 U.S.C. § 1498(a).

Courts ⇐ 449(3)

Robert S. Swecker, attorney of record, for plaintiff. *Donald F. Daley* and *Regis E. Slutter*, of counsel.

Thomas J. Scott, Jr., with whom was *Assistant Attorney General Rex E. Lee*, for defendant. *Robert G. Hilton*, of counsel.

Before COWEN, *Chief Judge*, DURFEE, *Senior Judge*, DAVIS, SKELTON, KASHIWA, KUNZIG, and BENNETT, *Judges*.

COWEN, *Chief Judge*, delivered the opinion of the court:

This case, before the court on defendant's motion for partial summary judgment, requires us to determine whether the alleged use of plaintiff's patented invention in the performance of a refuse collection contract was a use by or for the Government within the meaning of 28 U.S.C. § 1498(a).[1] Although this is, surprisingly, a case of first impression in this court,[2] the legal issues presented have arisen in a number of patent infringement cases in other courts.[3]

[1] 28 U.S.C. § 1498(a) provides in pertinent part that:

"Whenever an invention described in and covered by a patent of the United States is used or manufactured by or for the United States without license of the owner thereof or lawful right to use or manufacture the same, the owner's remedy shall be by action against the United States in the Court of Claims for the recovery of his reasonable and entire compensation for such use and manufacture.

"For the purposes of this section, the use or manufacture of an invention described in and covered by a patent of the United States by a contractor, a subcontractor, or any person, firm, or corporation for the Government and with the authorization or consent of the Government, shall be construed as use or manufacture for the United States."

[2] The court, however, has considered, in another context, the defense of lack of authorization or consent to patent infringement by a Government contractor. *See Allgrunn v. United States*, 67 Ct. Cl. 1, 44–48 (1928), *cert. denied*, 302 U.S. 725 (1937), (interpreting the Act of Oct. 6, 1917, ch. 95, 40 Stat. 394).

[3] *See, e.g., Croll-Reynolds Co. v. Perini-Leavell-Jones-Vinell*, 399 F. 2d 913 (5th Cir. 1968), *cert. denied*, 393 U.S. 1050 (1969); *Bereslavsky v. Esso*

Plaintiff, Carrier Corporation, is successor in interest to Dempster Brothers, Inc., and is owner by assignment of patents relating to certain features of refuse compactors and containers. Although the Government's motion for partial summary judgment is addressed solely to alleged infringement of plaintiff's patents resulting from the use of certain refuse handling equipment in the performance of a service contract awarded by the Department of the Air Force for the collection and removal of refuse at Andrews Air Force Base, resolution of the legal issues presented by the parties will simplify the remainder of the case which involves a number of other contracts awarded under substantially similar circumstances.

Under the Andrews contract, the contractor, Associated Refuse and Compaction Services, Inc. (Associated Refuse), was required, among other things, to furnish and install certain equipment, including refuse compactors and containers of specified size, at various locations on the base, and to remove at regular intervals all refuse collected in the containers. Since some of the facilities on the base were large enough to use efficiently stationary refuse compactors which compress solid waste into detachable containers, use of such equipment was expressly provided for by the terms of the contract.

Plaintiff originally claimed that it was entitled to compensation under 28 U.S.C. § 1498(a), because the refuse compactors and detachable containers utilized by Associated Refuse in the performance of the Andrews contract incorporated the subject matter of two of plaintiff's patents—No. 3,229,622, which relates to the refuse compactors, and No. 3,144,149, which relates to the detachable containers. However, since plaintiff has apparently withdrawn all claims involving the former patent, we need only consider plaintiff's allegations regarding the detachable containers.

In order to have jurisdiction of an action brought under 28 U.S.C. § 1498(a), this court must be satisfied that the use

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Standard Oil Co., 175 F. 2d 148 (4th Cir. 1949); *Molinaro v. Watkins-Johnson CEI Div.*, 359 F. Supp. 467 (D. Md. 1973). *See generally* Raubitschek, *Authorization and Consent-Another View*, 56 J. Pat. Off. Soc'y 634 (1974); TeSelle, *Authorization or Consent to Infringe Patents in Production for the Government*, 26 Geo. Wash. L. Rev. 583 (1958).

complained of is a use by or for the Government within the meaning of that section. Defendant, in support of its motion, contends that this court is without jurisdiction of any claims arising out of the Andrews contract, because any use by Associated Refuse of plaintiff's patented invention in the performance of that contract was not a use by or for the Government within the meaning of Section 1498(a). Since we find that we are in agreement with this contention, we grant defendant's motion for partial summary judgment.

The patented invention allegedly used in the performance of the Andrews contract is an apparatus for hoisting a detachable refuse container onto a truck bed for transportation to a dumping site and for placing the container back on the ground after it has been emptied. Obviously, such a device had a usefulness only with respect to Associated Refuse's duty to regularly pick up and empty all refuse containers at the base. It has no usefulness at all in relation to the function performed by the Government—i.e., the placing of refuse into the compactors and the activation of the devices electrically to compress the refuse into the detachable containers. Accordingly, we find that if there was any use of plaintiff's patented invention, such use was by the contractor and not by the Government.

A more difficult question, however, is whether the alleged use of plaintiff's patented invention was a use for the Government with its authorization or consent. Defendant contends that it expressly withheld its authorization and consent and, therefore, that any use of plaintiff's invention was not a use for the Government within the meaning of Section 1498 (a). Defendant bases this contention on the inclusion in the Andrews contract of a standard clause which limits the Government's authorization and consent to:

> all use and manufacture, in the performance of this contract * * * of any invention described in and covered by a patent of the United States (i) embodied in the structure or composition of any article the delivery of which is accepted by the Government under this contract, or (ii) utilized in the machinery, tools, or methods the use of which necessarily results from compliance by the Contractor or the using subcontractor

with (a) specifications or written provisions now or hereafter forming a part of this contract, or (b) specific written instructions given by the Contracting Officer directing the manner of performance.[4]

Defendant contends that since neither the contract specifications nor any specific written instructions from the contracting officer required Associated Refuse to use a particular type of equipment, the Government has not authorized or consented to any infringement of plaintiff's patent in the performance of the Andrews contract.[5] We agree.

The specifications of the contract require only that the detachable containers be "steel refuse containers that are fully enclosed and fireproof as specifically manufactured for refuse collection purposes." Technical Provision (TP) 3–05d. No structure or performance characteristics are required. Mr. Legrant Campbell, who, as technical representative of the contracting officer, was primarily responsible for administration of the contract, states unequivocally in an uncontroverted affidavit that "at no time was the particular equipment to be used in performance of the contract specified or required." Of similar thrust is the affidavit of Mr. Carroll David Case, the president of Associated Refuse, who states that "[n]either the written specification attached to the basic contract nor [the] Government technical representative who administered the performance of this contract ever specified any preference for a particular type of machine. The only

[4] *See* ASPR § 9–102.1, 32 C.F.R. § 9.102–1. The terms of this clause are considerably more narrow than the other standard clause used in defense contracts. *See* ASPR § 9–102.2, 32 C.F.R. § 9.102–2. That clause, which was designed for use in contracts calling for experimental, developmental, or research work, provides as follows:

"The Government hereby gives its authorization and consent for all use and manufacture of any invention described in and covered by a patent of the United States in the performance of this contract or any part hereof or any amendment hereto or any subcontract hereunder (including any lower-tier subcontract)."

Thus, to fall within the terms of this clause, the alleged use need only be in the performance of the contract.

[5] The portion of the authorization and consent clause that provides that the Government authorizes and consents to infringement of any patent "embodied in the structure or composition of any article the delivery of which is accepted by the Government" is applicable to hardware and other goods procured by and delivered to the Government for its own use, generally through supply contracts. Since the contract at issue is for services, the quoted portion of the clause is clearly inapposite.

requirement was that the devices furnished be capable of compacting refuse and that the containers be hauled away at specific intervals."

During the term of the Andrews contract, Associated Refuse's standard inventory included only detachable containers of the type plaintiff accuses of infringing its patent. During this entire period, however, detachable containers were available in the open market which could have been purchased and used, and which would not have infringed plaintiff's patent. In view of the general availability of non-infringing equipment, and the fact that use of equipment covered by plaintiff's patent was not required by the contract specifications or within instructions of the contracting officer, we find that the Government has not authorized or consented to any infringement of plaintiff's patent.

It is true, as plaintiff states, that the contract provides that:

> TP 3–03a: Positioning of all containers will be coordinated with the Contracting Officer or the Technical Representative.
>
> TP 3–05a: All equipment for use in accordance with the provisions of this Section shall become operative only after inspection and acceptance by the Contracting Officer or the Technical Representative.

These provisions alone, however, do not provide a sufficient basis for a finding that the Government authorized or consented to any infringement of plaintiff's patented invention. The first, TP 3–03a, appears to be intended merely to give the Government some control over the physical positioning of the containers on the base. The second, TP 3–05a, does provide that all equipment "shall become operative only after inspection and acceptance by the Contracting Officer or the Technical Representative." However, it is clear that the inspection and acceptance contemplated by that provision are only of a general nature and are intended merely to insure that the equipment complies with the contract specifications—i.e., that the containers are steel refuse containers of specified size and the compactors are capable of compacting refuse. In his affidavit, Mr. Campbell states that his pri-

mary duty, under the terms of the contract, including TP 3–05, was merely "to insure that all the services required under the contract were performed, namely that the trash containers were picked up, cleaned and replaced according to the required schedule" and "[t]hat he had no knowledge of the structure of the devices used." Under these circumstances, we cannot conclude that the mere inclusion of these provisions in the contract and the contractor's use of the allegedly infringing equipment, constitute sufficient evidence to establish the Government's authorization and consent. To hold otherwise would, in effect, mean that in every instance where the Government desires to avoid potential liability under Section 1498(a), it would be required to conduct a detailed and time-consuming investigation to determine whether the equipment the contractor selects for his own convenience infringes any outstanding patents.

Plaintiff attempts to avoid the effect of the authorization and consent clause by contending that the statute does not authorize the Government to limit its authorization and consent by the inclusion of such a clause in a contract. This contention, however, is contrary to Section 1498(a), which provides that:

> For the purposes of this section, the use or manufacture of an invention described in and covered by a patent of the United States by a contractor, a subcontractor, or any person, firm, or corporation for the Government and with the authorization or consent of the Government, shall be construed as use or manufacture for the United States.[6]

There is, unfortunately, no legislative history to aid us in interpreting this provision.[7] However, as we have frequently held, the language of the statute itself is the best indication of the intent of Congress. *See Lykes Bros. S.S. Co.* v. *United*

[6] 28 U.S.C. § 1498(a). The authorization and consent requirement, embodied in this provision, was judicially recognized as early as 1924 in *Wood* v. *Atlantic Gulf & Pac. Co.* 296 F. 718, 722–23 (S.D. Ala. 1924), but was not a specific statutory requirement prior to 1942. *See* Royalty Adjustment Act of 1942, Ch. 634, § 6, 56 Stat. 1014; Act of Oct. 31, 1951, ch. 655, § 50(c), 65 Stat. 727 (substantially incorporating Section 6 of the Royalty Adjustment Act into 28 U.S.C. § 1498(a)).

[7] *See* TeSelle, *supra* note 3, at 591–92.

States, 206 Ct. Cl. 354, 368, 513 F. 2d 1342, 1349 (1975). Since Section 1498(a) expressly provides that any use of a patented invention for the Government must be authorized or consented to, it is plain that the Government can limit its authorization and consent as it did in this instance.

Plaintiff relies heavily upon the Fifth Circuit's decision in *Croll-Reynolds Co.* v. *Perini-Leavell-Jones-Vinell*, 399 F. 2d 913 (5th Cir. 1968), *cert. denied*, 393 U.S. 1050 (1969). The defendants in that case were engaged in the construction for the United States of a portion of a dam across the Rio Grande River. The construction contract required that all concrete be cooled prior to pouring, but did not specify that the cooling be done by any particular method or process. The defendants installed cooling equipment at the site, as contemplated by the terms of the contract, and the contracting officer approved and paid for it. Plaintiffs, asserting that the defendants were using their patented method for cooling concrete, brought an action in the Federal district court seeking an injunction and damages. The district judge dismissed the action on the ground that the use of the cooling equipment was for the Government with its authorization and consent and, therefore, that the plaintiffs' sole remedy was in the Court of Claims. His decision was affirmed by the Fifth Circuit.

Although the contract in *Croll-Reynolds* contained the same authorization and consent clause that is in issue here, the court nevertheless found that the approval of and payment for the cooling equipment was conclusive evidence of the Government's authorization and consent. 399 F. 2d at 915. At first blush this decision would appear to be in conflict with ours, but we consider *Croll-Reynolds* to be distinguishable factually. For example, the cooling equipment utilized by the defendants in *Croll-Reynolds* was specially assembled for the dam project. 399 F. 2d at 915 (Godbold, J., concurring). In this case, however, the refuse equipment was taken from the contractor's general inventory, which was used to service both public and private clients. The defendants in *Croll-Reynolds* also were apparently paid in

full for the cost of constructing the cooling facility and equipment. *See* 399 F. 2d at 914–15 & n.3. Thus it appears that the Government, in effect, purchased the equipment. In this case, it is undisputed that the Government was paying Associated Refuse for its services—i.e., the collection and removal of refuse—and not for the refuse equipment itself. Despite these significant factual distinctions, we recognize that there are statements in the opinion of the Fifth Circuit which may be considered to be in conflict with this opinion. To the extent that this is true, we decline to follow *Croll-Reynolds*. However, we agree with the following statement in the concurring opinion of Judge Godbold: "That equipment is constructed by a contractor for use in the performance of a government contract, and is so used, do not alone constitute 'use' for the government within the meaning of 28 U.S.C.A. § 1498." 399 F. 2d at 916.

In view of the provisions of the contract and the undisputed facts before us, we hold that the service Associated Refuse performed at Andrews Air Force Base is not the type of activity that Congress, by enacting Section 1498(a), intended to cloak with immunity from injunction.[8] Plaintiff argues, nonetheless, that an injunction which would prevent Associated Refuse from using the patented equipment would interfere with the Government's need to dispose of its refuse. This argument, however, fails to take into account the fact that, if enjoined, Associated Refuse could complete the contract with alternative non-infringing equipment.

For the foregoing reasons, we conclude that plaintiff is not entitled to recover from the Government for any use under the Andrews contract of patent No. 3,144,149. Accordingly, it is ordered that defendant's motion for partial summary judgment is granted and plaintiff's petition dismissed to the extent that it seeks compensation for use by or for the Government of plaintiff's patented invention in the performance of the Andrews contract.

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[8] *See Richmond Screw Anchor Co.* v. *United States*, 275 U.S. 331, 342–43, 345 (1928); *Bereslavsky* v. *Esso Standard Oil Co.*, 175 F. 2d 148 (4th Cir. 1949); TeSelle, *supra* note 3, at 585–89.

Syllabus

529 F. 2d 1000

JOHN JOSEPH WHELAN *v.* THE UNITED STATES

[No. 14–74. Decided January 28, 1976. Defendant's motion for rehearing denied March 26, 1976]

ON DEFENDANT'S AND PLAINTIFF'S MOTIONS FOR SUMMARY JUDGMENT

Civilian pay; Foreign Service Act of 1946, as amended; GS salary on termination of assignment with Foreign Tax Assistance Staff.—Plaintiff, an Internal Revenue Service GS–14, step 3, employee, accepted a limited assignment pursuant to the Foreign Service Act of 1946, as amended, to the position of Public Administration Advisor—Tax, with the Foreign Tax Assistance Staff (FTAS), La Paz, Bolivia, effective August 2, 1964, at a salary of $15,675 equivalent to GS–15, step 1. On September 10, 1967 he was assigned to Honduras, serving until September 1969 when he returned to the United States. During this service he received within-grade and other pay increases and, coupled with conversion of the Foreign Compensation (FC) salary schedule from 14 grades to 12, effective July 13, 1969, at the expiration of the assignment he was in position FC–2, step 3, at a salary of $26,525 per year. At the time of the conversion, plaintiff had been holding an FC–3, step 6, position since July 28, 1968. That grade and step were then converted to FC–2, step 2, at a salary of $25,696. He thus held an FC–3, step 6, position or its equivalent for at least 1 year. On September 21, 1969 the Service assigned him to the position of Auditor, GS–14, step 10, at a salary of $24,093 rather than to GS–15, step 8, with a salary comparable to that which he had been receiving under FC–2, step 3. Following denial of his administrative appeals seeking retroactive assignment to a GS–15 position with retroactive pay, plaintiff filed the present suit for back pay and retirement credits allegedly due him in accordance with MT 1800–92, Sec. 183(10).9(2). It is *held* that the agency erred in not following the express language of its own regulation requiring that upon termination of assignments to FTAS, employees will have new GS salaries established on the basis of the salary of the highest FC grade held for one year, that the GS–14, step 10, slot assigned to plaintiff did not meet this standard since it resulted in a reduction in pay of $2,432 per year, and that in affirming the decision of the agency and the Appeals Examining Office, the CSC Board of Appeals and Review erred. Defendant's motion for summary judgment is denied, plaintiff's cross-motion is granted, the amount of recovery to be determined in further proceedings. The court directs the Secretary of the Treasury to correct plaintiff's record in accordance with this opinion.

Syllabus

Civilian pay; Foreign Service Act of 1946; GS salary on termination of assignment with Foreign Tax Assistance Staff.

[1] The language of the Foreign Service Act of 1946, as amended, does not require as a condition of an assignment to a Foreign Tax Assistance Staff, reversion to the employee's former or comparable GS grade upon his return to the United States.

United States ⇐ 39(2)

Statutes; construction and operation; ordinary meaning of terms.

[2] The ordinary and commonly understood meaning shall be attributed to the terms employed in a statute, unless a contrary meaning is clearly intended. This applies to the interpretation of administrative regulations.

Administrative Law and Procedure ⇐ 412
Statutes ⇐ 188

Civilian pay; Foreign Service Act of 1946; GS salary on termination of assignment with Foreign Tax Assistance Staff.

[3] Under Internal Revenue Service regulation MT 1800-92, Sec. 183(10).9(2), a GS salary for a returning employee from a Foreign Tax Assistance Staff (FTAS) who satisfactorily completed his tour must be established on the basis of the salary of the highest FC grade held for one year; a slotting in a GS grade at a salary "appropriate to the salary" the employee was earning with FTAS does not meet the more specific standard of the regulation where it results in a reduction in pay. The exercise of administrative discretion is not required.

United States ⇐ 39(2)

Regulation of Executive Department; binding effect of regulation.

[4] When a Government official or agency lawfully prescribes rules and procedures, these are binding on the Government as well as on its citizens, and where the rights of individuals are affected, it is incumbent upon agencies to follow their own regulations so long as they remain in force.

Administrative Law and Procedure ⇐ 416

John I. Heise, Jr., attorney of record, for plaintiff. *Barbara C. Miller* and *Heise and Jorgensen*, of counsel.

Richard J. Webber, with whom was *Assistant Attorney General Rex E. Lee*, for defendant. *Iraline G. Peniston* and *Peter A. Wissner*, of counsel.

Before LARAMORE, *Senior Judge*, KASHIWA and BENNETT, *Judges*.

205-676—76——45

KASHIWA, *Judge*, delivered the opinion of the court:

This case is before this court on cross motions for summary judgment. Material facts are not in dispute. We allow plaintiff's cross motion for summary judgment and deny defendant's motion for summary judgment for reasons hereafter stated.

Although this is an Internal Revenue Service (hereafter IRS) case, it relates to an interesting phase of IRS work less known to the public. An IRS employee with the consent of the Secretary of the Treasury may be assigned as a Reserve officer by the Secretary of State under the Foreign Service Act of 1946 as amended, 22 U.S.C. § 921 *et seq.* As such Reserve officer, he is assigned to foreign posts. In the present case the IRS employee was assigned first to Bolivia and later to Honduras. The pay problem in the case arose after the employee completed his service of about five years and returned to the IRS.

Plaintiff while employed by the IRS in the capacity of a Supervisory Auditor, Regional Inspector's Office, Chicago, Illinois, at grade GS–14, step 3, accepted a limited assignment under the aforesaid Foreign Service Act to the position of Public Administration Advisor—Tax, FC–3, in the Office of the Director, Foreign Tax Assistance Staff (hereafter FTAS), with a duty station at La Paz, Bolivia. This assignment, effective August 2, 1964, began at a salary of $15,675, which was equivalent at the time of a grade GS–15, step 1. Plaintiff's limited assignment to La Paz, Bolivia, was extended several times; and on September 10, 1967, he received a change in duty station from Bolivia to Honduras.

Plaintiff served with the FTAS for a period slightly in excess of five years. During this time he received numerous within-grade increases as well as a "high quality increase" in salary. As a result of these pay elevations, coupled with a statutory increase, and the conversion of the Foreign Compensation (hereafter FC) salary schedule from 14 grades to 12, plaintiff held the position of FC–2, step 3, at a salary of $26,525, at the expiration of his limited assignment to the FTAS in September, 1969.

The conversion of the FC salary schedule from 14 grades to 12, effective July 13, 1969, was made pursuant to AID

Notice No. 73, dated July 8, 1969. At the time of the conversion, plaintiff had been holding an FC grade 3, step 6 position since July 28, 1968. That grade and step were then converted on the FC salary schedule to FC grade 2, step 2, at a salary of $25,696. Plaintiff thus held an FC grade 3, step 6 position or its equivalent (in reslotting to FC–2, step 2) for at least one year. He even received another within-grade increase prior to the expiration of his assignment to the FTAS. As a result, the nearest position to plaintiff's FC–2, step 3 classification, with salary at $26,525, at the time of his return to a state-side assignment was General Schedule grade GS–15, step 8, with a salary of $26,629.

Instead of receiving the classification of GS–15, step 8, which plaintiff had anticipated he would receive and to which he believed he was entitled, he was assigned to the position of Auditor (Special Assistant), GS–14, step 10, at a salary of $24,093. This resulted in a reduction in salary upon his return to state-side duty of $2,432 per annum. In questioning the propriety of his salary reduction, he initiated a grievance concerning his assignment to a GS–14 position instead of the comparable GS–15, step 8 slot. The steps he took are listed in the margin.[1] Plaintiff filed his petition in this court on January 8, 1974. He seeks back pay and retirement credits due because of his improper assignment effective September 21, 1969, to the grade of GS–14, step 10, in-

[1] Plaintiff's grievance was considered by the Internal Revenue Service at a first-level conference on October 20, 1972; and by a decision dated November 15, 1972, the Chief Placements Section denied plaintiff's grievance. On November 20, 1972, plaintiff appealed the matter further to the Chief of the National Office Branch, Personnel Division, IRS, seeking retroactive assignment to a GS–15 position with retroactive pay. In a decision dated November 27, 1972, the Chief of the agency's National Office Personnel Branch concluded that the matter was not covered by IRS grievance procedures. On November 29, 1972, plaintiff filed an appeal with the Appeals Examining Office of the United States Civil Service Commission (hereafter CSC). The Appeals Examining Office of the CSC on December 20, 1972, declined to entertain plaintiff's appeal of his "alleged improper reinstatement on September 21, 1969 as it does not fall within the purview of the Commission's appellate jurisdiction." Plaintiff on January 3, 1973, sought further clarification from the Appeals Examining Office of his appeal. A response thereto was made on January 12, 1973, contending that further action must be before the Board of Appeals and Review of the CSC. By letter dated January 26, 1973, plaintiff appealed to the Board of Appeals and Review of the CSC. By a decision dated April 10, 1973, the Board denied plaintiff's claim and reaffirmed the decision of the Appeals Examining Office.

stead of to the position of GS–15, step 8, to which plaintiff claims the IRS was obligated to return him.

We quote at the outset the regulations as set forth by the agency in MT 1800–92 (1–5–68) of the IR Manual, particularly Section 183(10).9 entitled "Procedures for Returning Employees from FTAS," which provides in subparagraph (2) as follows:

> (2) Upon termination of assignments to FTAS, employees returning to the General Schedule (GS), who have satisfactorily completed overseas tours of at least one year, will have new GS salaries established on the basis of the *salary of the highest FC grade held for one year.* Should an employee's current FC salary fall between two GS step rates, the employee will be given the *higher* GS step. The new GS salary of an employee who did not satisfactorily complete an overseas tour of at least one year, will be set at the grade and step at which it would be had the employee not received an assignment with FTAS. Exceptions to the preceding salary-setting rules may be authorized by the Director, Personnel Division, when the best interests of the Service are involved." [Emphasis supplied.]

Defendant does not make a claim of exception predicated upon "the best interests" of the agency.

Plaintiff's entire suit is based on this regulation. He contends that the terms of this regulation were not complied with when the agency failed to assign plaintiff to the GS–15 grade upon completion of his overseas assignment. There is no question that plaintiff at all times satisfactorily performed his overseas assignment. He argues that he was entitled to a GS–15 slot based on his salary in the "highest FC grade held for one year."

Defendant's brief well sets out plaintiff's grades and salaries for the one year preceding the expiration of plaintiff's limited assignment. We reproduce the chronology herein:

July 28, 1968—FC–3/6, $23,122.
July 13, 1969—(Pay System Change, Conversion in FC Salary Schedule from 14 to 12 Grades).
From: FC–3/6, $23,122.
To: FC–2/2, $25,696.
July 27, 1969—Within Grade Increase—FC–2/3, $26,525.
September 21, 1969—Expiration of Assignment.

Based on the above chronology, plaintiff argues that he held the grade of FC–3, step 6 or its equivalent (in reslotting FC–2/2), for at least one year and was entitled to receive a GS–15 position upon the expiration of his limited FTAS assignment.

Defendant argues that reversion to plaintiff's former or comparable GS–14 was a condition of his FTAS assignment. It is unable to point to any specific statute or regulation requiring such a condition. We hold that no such condition existed and such is not required by the language of the Foreign Service Act. The pertinent IRS regulation, Section 183(10).9(2), which is cited above, provides quite differently by *assuring* the employee that his new GS salary shall be "established on the basis of the salary of the highest FC grade held for one year."

The "plain meaning" rules of statutory construction[2] apply to the interpretation of administrative regulations. *Akins* v. *United States*, 194 Ct. Cl. 477, 486, 439 F. 2d 175, 179 (1971); *Selman* v. *United States*, 204 Ct. Cl. 675, 681–83, 498 F. 2d 1354, 1356–58 (1974). The terms of the applicable administrative regulation (MT 1800–92, Section 183(10).9) are clear in this case. We hold that the agency erred in ignoring the express language.

The decision of the Board of Appeals and Review of the Civil Service Commission (hereafter BAR) is erroneous and not in keeping with the mandate provided by the agency's own regulations. The decision states in part as follows (p. 3):

> The appellant was returned to the IRS in a like position to the one he occupied prior to his assignment with AID. By placing him in the top step of the grade, the agency fulfilled its obligation to give him a salary *appropriate to the salary* he was earning with FTAS. The agency thus complied with the law and regulations, PL 87–195, governing the reinstatement of the appellant and, under the circumstances, there could be no demotion as that term is applied to personal actions. [Emphasis in original.]

[2] It is well established in this court that the ordinary and commonly understood meaning shall be attributed to the terms employed in a statute, unless a contrary meaning is clearly intended. *Benton* v. *United States*, 203 Ct. Cl. 263, 269, 488 F. 2d 1017, 1020 (1973); *Coleman* v. *United States*, 93 Ct. Cl. 127, 131–33, 37 F. Supp. 273, 276 (1941); *Akins* v. *United States*, 194 Ct. Cl. 477, 486, 439 F. 2d 175, 179 (1971); *Boege* v. *United States*, 206 Ct. Cl. 560 (1975).

We find that the GS–14, step 10 slot assigned to plaintiff did *not* compensate him, to use the language of the BAR, with "a salary *appropriate to the salary* he was earning with FTAS" since it resulted in a reduction in pay of $2,432 per annum. Nor did it meet the more specific standard of the agency's own regulations providing for a new GS salary "established on the basis of the salary of the highest FC grade held for one year."

The binding force and effect of administrative regulations regarding personnel, and the adversely affected employee's right to corrective action (including salary lost) following violation or omissions thereof, were clearly defined by the Court in *Vitarelli* v. *Seaton*, 359 U.S. 535 (1959), and *Service* v. *Dulles*, 354 U.S. 363 (1957), as well as by this court in *Jones* v. *United States*, 203 Ct. Cl. 544 (1974); *Cason* v. *United States*, 200 Ct. Cl. 424, 471 F. 2d 1225 (1973); *Fletcher* v. *United States*, 183 Ct. Cl. 1, 392 F. 2d 266 (1968); *Conn.* v. *United States*, 180 Ct. Cl. 120, 376 F. 2d 878 (1967); *Cole* v. *United States*, 171 Ct. Cl. 178 (1965); *Middleton* v. *United States*, 170 Ct. Cl. 36 (1965); *Smith* v. *United States*, 155 Ct. Cl. 682 (1961); *Daub* v. *United States*, 154 Ct. Cl. 434, 292 F. 2d 895 (1961); and *Watson* v. *United States*, 142 Ct. Cl. 749, 162 F. Supp. 755 (1958). When a Government official or agency lawfully prescribes rules and procedures, these are binding on the Government as well as on its citizens. *Yellin* v. *United States*, 374 U.S. 109 (1963); *Accardi* v. *Shaughnessy*, 347 U.S. 260 (1954); *Chapman* v. *Sheridan-Wyoming Coal Co.*, 338 U.S. 621 (1950); *Bridges* v. *Wixon*, 326 U.S. 135, 153 (1945); *Bilokumsky* v. *Tod*, 263 U.S. 149, 155 (1923).

In *Morton* v. *Ruiz*, 415 U.S. 199 (1974), the Court stated at p. 235:

> Where the rights of individuals are affected, it is incumbent upon agencies to follow their own procedures. * * *

And in *United States* v. *Nixon*, 418 U.S. 683 (1974), the Court stated at p. 696:

> * * * So long as this regulation remains in force the Executive Branch is bound by it, and indeed the United

States as the sovereign composed of the three branches is bound to respect and enforce it. * * *

The claim here involves simply a slotting process stemming from the regulations applicable to employees returning from the FTAS. The situation is analogous to that of *Kellerman* v. *United States*, 205 Ct. Cl. 484, 490, 504 F. 2d 1128, 1132 (1974), wherein this court said:

> * * * The court's reasoning there [*Nordstrom* v. *United States*, 177 Ct. Cl. 818 (1966)] is equally applicable to the present dispute:
>
> > In the instant case, no exercise of discretion is required. Plaintiff is not seeking a promotion—he is seeking the benefit incident to a reclassification, an automatic action which applied to everyone [in plaintiff's position].
>
> 177 Ct. Cl. at 825. The case now at bar involves not a general reclassification of grade level but a similar general removal of a wage ceiling.

Just as in *Kellerman*, plaintiff had already received the promotion as a result of his meritorious service in the FTAS. This was an accomplished fact. The "automatic" salary slotting for the GS grade necessarily follows. The agency did not follow its own regulations. In affirming the decision of the agency and the Appeals Examing Office, the BAR erred.

BENNETT, *Judge*, joined by Laramore, *Senior Judge*, concurring:

I deem it advisable and necessary to add a few words to the able opinion of Judge Kashiwa, in which I join. I agree that this case is ruled by a proper construction of IR Manual § 183(10).9(2), but would make that construction a bit more explicit.

The first sentence of subparagraph (2) reaches employees returning to the General Schedule from FTAS having satisfactorily completed tours of at least 1 year, such as the plaintiff. It states that the new salary of such an employee, on return, will be established by reference to the salary of the highest FC *grade* held for 1 year. The first sentence does not refer to the highest grade and *step* held for 1 year, a fact

which seems occasionally to have escaped the parties. The second sentence goes on to discuss the *step* within grade, to which a returning employee will be assigned. Where the final FC-scale salary happens to fall between two steps within the appropriate GS grade, the returning employee will be entitled to the salary of the higher.

Given this construction we must decide whether the plaintiff held the *grade* of FC–2 or FC–3 for more than 1 year. The evidence indisputably shows that plaintiff's reslotting to FC–2 from FC–3 involved neither a promotion nor a demotion, but was merely the consequence of a reduction in the number of FC grades from 14 to 12. It is also true, however, that the FC–2 grade was assigned to plaintiff less than 1 year before his return to the General Schedule. On the peculiar facts of this case we have decided that in legal contemplation, the FC–2 grade does not differ from that of FC–3. Thus, we think it entirely permissible to say that for purposes of IR Manual § 183(10).9(2), plaintiff in effect held the grade of FC–2 for more than 1 year. The parties agree that FC–2 is equivalent to GS–15.

It remains only to determine the appropriate step within the grade of GS–15 to which plaintiff is entitled. The second sentence of subparagraph (2) makes this a simple matter—on return, plaintiff was entitled to the lowest step of GS–15 having a salary equal to or greater than that of his final FC grade and step.

The Internal Revenue Service clearly erred in applying its own procedures when it assigned this plaintiff to the grade and step of GS–14, step 10. I agree that plaintiff is entitled to recover.

CONCLUSION

Defendant's motion for summary judgment is denied and plaintiff's cross motion for summary judgment is granted. The amount of recovery will be determined pursuant to Rule 131(c). Pursuant to Rule 147(c), this court directs the Secretary of the Treasury to correct plaintiff's records in accordance with this opinion.

Syllabus

530 F. 2d 374

McCLOSKEY & COMPANY v. THE UNITED STATES

[No. 406–74. Decided January 28, 1976. Plaintiff's motion to amend judgment denied March 26, 1976]

ON DEFENDANT'S MOTION TO DISMISS

Court of Claims jurisdiction; contract claim; nonappropriated fund activity; District of Columbia Armory Board.—Plaintiff entered into a contract with the District of Columbia Armory Board for construction of the Robert F. Kennedy Stadium, and brings this action under 28 U.S.C. § 1491 for Wunderlich Act review of a decision of the District of Columbia Contract Appeals Board denying plaintiff's various contract claims seeking recovery of increased costs. In 1957 Congress authorized the Board to contract for construction of the stadium, all costs of planning, designing and construction to be financed by the Board's issuance of bonds. It is *held* that the claim is without this court's general jurisdiction under 28 U.S.C. § 1491 since the United States was neither directly a party to the contract nor, more importantly, were appropriated public funds involved. It is evident from the congressional financing scheme enacted for construction of the stadium and the legislative debate surrounding the stadium act that plaintiff's contract was not to be satisfied out of appropriated funds. Accordingly, defendant's motion to dismiss is granted, and the petition is dismissed.

Court of Claims jurisdiction; contract claims; generally.

[1] This court's general jurisdictional statute, 28 U.S.C. § 1491, restricts jurisdiction to claims against the United States founded upon an express or implied contract with the United States. To be actionable in this court the contract sued upon must be one which can be satisfied out of appropriated funds.

Courts ⇐ 449(1)

Court of Claims jurisdiction; nonappropriated fund activity.

[2] Where Congress authorized the District of Columbia Armory Board to contract for construction of a stadium facility in the District of Columbia and directed that costs of planning, designing and constructing such stadium should be financed from the Board's issuance of bonds and specifically limited financial liability for the undertaking to the funds so generated and not to public monies, a claim based on the contract activities of the Board is outside this court's Tucker Act jurisdiction. Assuming, *arguendo*, that the Board's construction of the stadium was a Federal project and that the Federal Government owns the stadium, this is not enough to provide a basis for this court's jurisdiction since the contract with the Board was not one which could be satisfied out of appropriated funds.

Courts ⇐ 449(1)

Gilbert A. Cuneo, attorney of record, for plaintiff. *Thomas L. Patten*, *Sellers*, *Conner & Cuneo*, of counsel.

David R. Schlee, with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Before DURFEE, *Senior Judge*, NICHOLS, *and* KASHIWA, *Judges*.

DURFEE, *Senior Judge*, delivered the opinion of the court:

Plaintiff's present contract claims arise from its construction of the District of Columbia (now Robert F. Kennedy) Stadium. In 1960, plaintiff contracted with the District of Columbia Armory Board (Board) for the construction of a stadium facility in the District of Columbia. The Armory Board's contracting officer accepted the stadium as complete on April 9, 1962. Following completion of the stadium, plaintiff filed various contract claims with the contracting officer. The contracting officer denied all of plaintiff's claims.

Thereafter, plaintiff appealed the contracting officer's denial of its claims to the District of Columbia Contract Appeals Board, the forum designated in the parties' contract to hear such claims. That Board denied plaintiff's claims entirely. Plaintiff subsequently petitioned this court under our general jurisdiction statute (28 U.S.C. § 1491) for review of the District of Columbia Contract Appeals Board decision under the standards of the Wunderlich Act (41 U.S.C. §§ 321, 322). Defendant responded to plaintiff's petition with a Rule 38(b) motion to dismiss for lack of court jurisdiction. Defendant's motion is granted.

The court's general jurisdictional statute, 28 U.S.C. § 1491, restricts our jurisdiction to claims against the United States founded upon an express or implied contract with the United States.

In order to present an actionable contract claim cognizable within this jurisdiction the contract sued upon must be one which can be satisfied out of appropriated funds. *Manning* v. *United States*, 200 Ct. Cl. 756 (1973). This is because, as we explained in *Kyer* v. *United States*, 177 Ct. Cl. 747, 751–52, 369 F. 2d 714, 717–18 (1966), *cert. denied*, 387 U.S. 929 (1967):

Opinion of the Court

> The jurisdiction of this court under the Tucker Act encompasses "any claim against the United States: * * * founded upon any express or implied contract with the United States; * * *." While the terms of this statute are broad, its words must be read in conjunction with and must be regarded as limited by another statute which provides that our judgments are paid only from appropriated funds. Thus, to remain within the framework of our jurisdiction, it is essential that the contract sued on be one which could have been satisfied out of appropriated funds. It is not enough to say, as plaintiff does, that his contract was one to which the United States was a party. To be actionable *in this court*, that contract must be one which, in the contemplation of Congress, could obligate public monies. *G. L. Christian & Associates* v. *United States*, 160 Ct. Cl. 1, 14, 312 F. 2d 418, 425, *cert. denied*, 375 U.S. 954 (1963). If Congress has indicated that public funds shall not be involved, we cannot grant the relief requested. * * *[1]

In the instant case, the United States was neither directly a party to the underlying contract nor, more importantly, were appropriated public funds involved.

Congress created the District of Columbia Armory Board in 1948 "* * * to provide facilities for the quartering and training of the Militia of the District of Columbia, and, secondarily, to provide suitable facilities for major athletic events, conventions, concerts, and such other activities as may be in the interest of the District of Columbia * * *." 2 D.C. Code § 1701.[2]

At the time of its creation, Congress provided the Board with a permanent revolving working capital fund to cover the Board's expenses in the exercise of its initial responsibilities. Congress later expanded the Board's use of this fund to include its office and sundry expenses, and for change-making purposes in connection with the Board's operation of the stadium. 2 D.C. Code § 1708.

In 1957 Congress authorized the Board to contract for construction of a stadium facility in the District of Columbia. 2 D.C. Code § 1720. Congress directed that "the cost of planning, designing and constructing such stadium"

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[1] Emphasis in original; footnotes omitted.

[2] Official statutory citations for the D.C. Code appear in the code following the cited code section.

should come not from an appropriation of public funds but rather from the Board's issuance of bonds. 2 D.C. Code § 1722. The Congressional-authorizing legislation placed several restrictions on the Board's bond-issuing authority including the condition that the issuance of the bonds "shall be so calculated as to produce, at the price of their sale, the cost of the stadium constructed pursuant to this subchapter." 2 D.C. Code § 1722.

Under the Congressionally-enacted stadium financing scheme all proceeds from the Board's bond sales were to be placed in an operating fund and that fund utilized for *all* the costs of stadium construction. 2 D.C. Code § 1724. In addition to the operating fund for payment of stadium construction costs, Congress authorized the creation of a sinking fund for retirement of the Board's principal and interest obligations on its bond issues. Into this fund were to be placed the excess of the operating fund, if any, after the payment of construction and other specified stadium expenses and all stadium operating revenues. In the event that the amount in the sinking fund was insufficient to meet the Board's bond obligations, Congress authorized the Board, acting through the Commissioners of the District of Columbia, to request sufficient amounts out of the revenues of the District of Columbia, or borrow the necessary funds from the Secretary of the Treasury from specified funds held by the Secretary. Board loans from the Secretary of the Treasury were to be repaid promptly with interest. 2 D.C. Code § 1727.

Incident to the Board's authorization to construct the stadium Congress directed the Secretary of the Interior to acquire and prepare a designated site for construction of the stadium. 2 D.C. Code § 1721. In addition, Congress provided that all bonds issued by the Board would be guaranteed as to both principal and interest by the United States. 2 D.C. Code § 1727. Further, Congress required the Board to make annual financial reports to the Congress, and provided that after the payment of the stadium bonds and interest, but not later than 2007, all right, title and interest in the stadium shall vest in the United States. 2 D.C. Code §§ 1728, 1725.

Congress, in providing the financial arrangements for the Board's construction of the stadium, specifically limited the financial liability for this undertaking to the funds generated by the Board's bond issuances.

> Nothing contained in this subchapter shall be construed to authorize or permit the Board or any member thereof to create any obligation or incur any liability other than such obligations and liabilities as are dischargeable solely from funds contemplated to be provided by this subchapter. No obligation created or liability incurred pursuant to this subchapter shall be a personal obligation or liability of any member or members of the Board but shall be chargeable solely to the funds contemplated to be provided by this subchapter. * * *[3]

During Congressional consideration of the District of Columbia Stadium Act, one of the House managers of the legislation explained this provision thusly:

> "MR. MCMILLAN. * * * The bill provides that the liabilities created by the Board and its members shall be restricted to those chargeable solely to the funds contemplated by this act. No indebtedness created pursuant to this act shall be an indebtedness of the District of Columbia or of the United States. * * *"[4]

Other Congressional debate on the act emphatically makes the same point that Congress intended to restrict construction funding of the stadium to the funds created by the Board's sale of bonds.

> "MR. BARRETT. Does the Senator understand that under the provisions of the bill the construction would be carried out by the sale of bonds, and would not call for an appropriation by the United States Government?
>
> "MR. LAUSCHE. I thoroughly understand that that is supposed to be the fact, and that this is supposed to be a self-liquidating project. * * *.
>
> "MR. BARRETT. It is not a Federal project in the sense that Congress will appropriate money for it.
>
> * * * * * *
>
> "MR. BIBLE. I respect the Senator's right to object to the consideration of the bill. However, I should like to

[3] 2 D.C. Code § 1727.
[4] 103 Cong. Rec. 6824 (1957).

say to him that the bill has had the very careful consideration of our committee. The bill in no way requires Federal participation, with the exception of the original borrowing of $35,000 for the economic survey. Even that is merely a loan, which is to be repaid out of the sale of the bonds to be issued, which will be retired by revenues collected by the stadium. This is not a Federal project." [5]

* * * * *

"MR. GROSS. Last year the House authorized $5 million for the building of a stadium at Cleveland, Ohio, but this year that was wiped out. There will be no stadium at Cleveland, Ohio. Congress did not make an appropriation for it. I am glad they did not.

"MR. HARRIS. If the gentleman will yield, that money was to be provided out of the Treasury of the United States. This is not. This is a private operation and will cost the Government nothing for the construction of the stadium, * * *." [6]

It is evident from an examination of the Congressional financing scheme enacted for the construction of the stadium and the legislative debate surrounding the stadium act that plaintiff's contract cannot be satisfied out of appropriated funds and that Congress has indicated that public funds shall not be involved. Accordingly, as in *Kyer*, *supra*, we cannot grant the relief requested.

Plaintiff attempts to avoid the jurisdictional bar of *Kyer* by contending that the United States owns the stadium, that its construction was a Federal project and that our prior decisions in *Butz Engineering Corp.* v. *United States*, 204 Ct. Cl. 561, 499 F. 2d 619 (1974), and *Breitbeck* v. *United States*, 205 Ct. Cl. 208, 500 F. 2d 556 (1974), provide a basis for court jurisdiction of the instant case.

We note in this regard that plaintiff in its opposition to defendant's motion did not come to grips with the *Kyer* case nor even refer to that case in its opposition. Rather, plaintiff chose to rebut the holding of *Kyer* by ignoring it, and relies instead on other factors which can be distinguished from the present case and *Kyer*. Plaintiff relies on several factors, notably the D.C. Circuit Court's decision in *Heoht*

[5] 103 Cong. Rec. 13567 (1957).
[6] 103 Cong. Rec. 15385 (1957).

v. *Pro-Football, Inc.*, 444 F. 2d 931 (D.C. Cir. 1971), *cert. denied*, 404 U.S. 1047 (1972), to establish the proposition that the Armory Board is a United States Government instrumentality, the Board's construction of the stadium was Federal action and the Federal Government owns the stadium, Even accepting plaintiff's contentions as true, a point on which we express no opinion, the facts still remain that plaintiff's contract with the Board was not one which could be satisfied out of appropriated funds, and Congress unambiguously expressed the intent that public funds should not be involved in the construction of the stadium. Hence, under *Kyer*, *supra*, *Manning* v. *United States*, *supra*, and *Interdent Corp.* v. *United States*, 203 Ct. Cl. 296, 488 F. 2d 1011 (1973), plaintiff's claim is not vindicable in this court. "It is not enough to say, as plaintiff does, that his contract was one to which the United States was a party." *Kyer* v. *United States*, *supra*, 177 Ct. Cl. at 751, 369 F. 2d at 718.

Our prior decisions in *Butz Engineering Corp.* v. *United States*, *supra*, and *Breitbeck* v. *United States*, *supra*, provide no basis for court jurisdiction in the present case. Both decisions are readily distinguishable both on their facts and the issues involved from the instant case. In *Butz*, the court accepted jurisdiction over a contract claim involving the United States Postal Service, finding that Congress in reorganizing the Postal Service as an independent Government corporation had not intended to abandon general financial responsibility for the Postal Service. In the instant case, Congress specifically excluded the United States from financial liability for the Board's construction of the stadium, and deliberately left the Board exclusively to private sources of funding. *Breitbeck*, a civilian pay case by employees of the Saint Lawrence Seaway Development Corporation, involved the question of whether disgruntled corporation employees had stated a "claim against the United States." *Breitbeck* v. *United States*, *supra*, 205 Ct. Cl. at 214, 500 F. 2d at 560. The court accepted jurisdiction in that case, finding (1) that while the corporation was eventually to be self-financing, Congress intended to carry the project out of general Treasury or appropriated funds until such time as it

was self-financing and (2) that plaintiff-employees were covered by the Classification Act, 5 U.S.C. § 5101 *et seq.*

In the present case, Congress, from the beginning, did not make available general Treasury or appropriated funds nor intended to make available such funds to the Board for the construction of the stadium. Additionally, the Board's employees were not covered by the Classification Act, 2 D.C. Code § 1726.

For the reasons stated, defendant's motion to dismiss is granted, and plaintiff's petition is dismissed.

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530 F. 2d 324

AERO SPACELINES, INC. v. THE UNITED STATES

[No. 589–71. Decided January 28, 1976]

ON THE PROOFS

Renegotiation of contracts; redetermination of excessive profits; factors to be considered in determining excessiveness; sole-source supplier of air transportation services for oversize cargo.—Plaintiff, under a contract subject to renegotiation, was a sole-source supplier to the National Aeronautics and Space Administration of air transportation services for NASA items too large to be transported in conventional cargo aircraft. Plaintiff transported the items from the west coast, where they were assembled, to Kennedy Space Center in Florida, in two specially fabricated unique aircraft known as the "Pregnant Guppy" and the "Super Guppy." Dissatisfied with the determination by the Renegotiation Board that it realized excessive profits of $250,000 during fiscal year 1966, the plaintiff seeks de novo redetermination of the excessive profits, if any. After careful consideration of all the facts, the statutory factors to be considered in determining excessiveness, and the submissions of the parties, it is *held* that plaintiff has made a prima facie showing that it did not realize excessive profits in 1966, and that the Government has failed to demonstrate by a preponderance of the evidence either that plaintiff's profits were excessive or the amount of the alleged excess. Plaintiff is entitled to a refund of the amount paid to defendant, together with interest as provided by the Renegotiation Act of 1951, as amended.

Renegotiation of contracts; redetermination of excessive profits; weighted guidelines method of determining reasonable profits. [1] The use of the weighted guidelines method of determining reasonable profits (or a method patterned on that system) is not automatically forbidden in renegotiation, if properly used, but that

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method has some inherent dangers in assessing performance after the fact which must be carefully guarded against.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; Renegotiation Board order; presumption.

[2] In Court of Claims renegotiation proceedings, no presumption of correctness is accorded the Renegotiation Board's order determining excessive profits.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; evidence; burden of proof and persuasion.

[3] In de novo redeterminations by this court of the amount of excessive profits, if any, realized by a Government contractor subject to the Renegotiation Act of 1951, as amended, the burden rests upon the Government both to persuade the court that a contractor realized excessive profits and to prove the extent of the excessive profits. This is so despite the fact that the contractor, as plaintiff, is nominally the moving party; thus, the contractor may institute de novo proceedings in the Court of Claims unfettered by any prejudice from the agency proceeding.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; evidence; burden of proof and persuasion.

[4] Having the burden of persuasion that a contractor realized excessive profits, the Government bears the risk of nonpersuasion if the evidence in the case should be in equipoise.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; evievidence; burden of proof and persuasion.

[5] Although the Government must bear the unshiftable risk of nonpersuasion that a contractor realized excessive profits, the contractor has the initial burden of going forward with proof as to the statutory factors upon which it relies to the extent that the facts pertaining thereto are within its knowledge or possession, are accessible to the public generally in the form of published reports, or are actually made available to the contractor by the Government. Normally, when the contractor does this, it will have made a prima facie case, which, unless rebutted, justifies a judgment in accord with the contractor's contention. The contractor's obligation to proceed first is not an empty formality.

War and National Defense ⇐ 59

Pleading and practice; stipulations; relief of party from stipulation.

[6] Although the court will occasionally relieve a party of its stipulation if necessary to prevent an injustice, particularly where facts contrary to the stipulation are established by the evidence, the

Syllabus

general rule is that absent special considerations, parties are bound by their stipulation on issues of fact. Thus, where plaintiff employed an established cost accounting method and the parties stipulated the dollar amount, respectively, of plaintiff's renegotiable sales, costs and profits and stipulated that the figures were not subject to contradiction by additional, conflicting facts, plaintiff may not ask the court to recognize additional costs, neither reflected upon plaintiff's books nor included in the accounting statement to which the parties stipulated, which would correspondingly reduce plaintiff's profits; plaintiff has not demonstrated that deviation from the general rule is appropriate.

Stipulations ⟸ 13

Renegotiation of contracts; redetermination of excessive profits; discretion of court to redefine costs.

[7] Sec. 103(f) of the Renegotiation Act of 1951, as amended, confers upon the Court of Claims discretion to redefine costs, but only in situations in which a contractor either has not employed a regular method of accounting or has employed a method which does not properly reflect its cost of doing renegotiable business. Where plaintiff has not shown facts to suggest that use of the standard accounting principle that property is depreciated over its useful life would cause plaintiff's costs to be misstated, the court will not use its discretion to modify plaintiff's chosen and established cost accounting method. A principal advantage of consistent adherence to Internal Revenue Code accounting methods mandated in Sec. 103(f) is the uniformity which those methods provide over several years of renegotiable business.

War and National Defense ⟸ 59

Renegotiation of contracts; redetermination of excessive profits; discretion of court to redefine costs.

[8] Where plaintiff's acquisition of R corporation which designed and fabricated the contracted item qualified as a tax-free reorganization, where plaintiff and defendant stipulated that the purchase price exceeded the value of the net assets on the books of R by a stated amount, but where no portion of this excess was amortized or otherwise charged against plaintiff's sales in determining profits subject to renegotiation, plaintiff may not now amortize the excess absent a showing that the "pooling of interests" method, which it used for federal income tax purposes and which closely paralleled the tax accounting method mandated by Secs. 361 and 362 of the Internal Revenue Code of 1954 for a tax-free reorganization, is manifestly unsuitable for renegotiation purposes because it does not clearly reflect the profits attributable to plaintiff's performance of its renegotiable contract in 1966. Further, application of the purchase method (amortization) would present difficult problems of valuation, because plaintiff has not assigned fair values to the

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"identifiable assets" (tangible and intangible) acquired in the transaction.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; factors to be considered.

[9] Sec. 103(e) of the Renegotiation Act of 1951 sets forth the statutory factors to be considered in determining excessive profits, namely: reasonableness of costs and profits, net worth and capital employed, risks assumed, contribution to the defense effort, character of business, and any other factors required to do equity and serve the public interest. 32 C.F.R. § 1460.8(a) underscores the importance of comprehensive evaluation, in terms of all the statutory factors, of a renegotiated contractor's performance in the fiscal year under review. "Comprehensive evaluation" is not synonymous with purely subjective determination.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; generally.

[10] The parties to a renegotiation proceeding must present to this court enough information to enable it to render a decision based upon reasoning cogent enough to warrant the conclusion that any reasonable and fairminded man, exercising an informed business judgment, would reach approximately the same result.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; specific considerations.

[11] In the court's evaluation of a contractor's performance, comparative analysis of prices, costs and profits of other contractors engaged in production of the same or similar products is essential in order to give the statutory factors concrete dollars and cents meaning.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; factors to be considered; character of business.

[12] In determining the amount of excessive profits, if any, realized by a sole-source supplier of air transportation services for NASA oversize shipments, the unusual character of the contractor's business and its willingness to design and build a special purpose aircraft at its own risk and expense are important factors in establishing a prima facie case of reasonableness of its profits. The fact that the contractor used Government-furnished military surplus equipment in operating the aircraft does not warrant reducing its profit where the record suggests that such use was one source of its cost effectiveness and that as a result cost savings were passed on to the Government. An additional element contributing to the

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contractor's establishment of its prima facie case is employment of its own facilities and skill in contract performance.

War and National Defense ⇐ 59

Renegotiation of contracts; Court of Claims jurisdiction; review of Renegotiation Board decisions; exemptions from renegotiation.

[13] Under Sec. 106(a)(6), as amended, the Court of Claims does not have jurisdiction to review the Renegotiation Board's decision holding that plaintiff's contract did have a direct and immediate connection with the national defense and was, accordingly, not entitled to exemption from renegotiation.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; factors to be considered; contribution to the defense effort.

[14] In determining the amount of excessive profits, if any, realized by a sole-source supplier of air transportation services for NASA oversize shipments, favorable consideration should be given the contractor for its ingenuity in recognizing the need for and in implementing the means to provide a unique and exceptional air transportation service meeting NASA's need for speed and flexibility in carrying components used in the space program.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; factors to be considered; extent of risk assumed.

[15] In determining the amount of excessive profits, if any, realized by a sole-source supplier of air transportation services for NASA oversize shipments, risks to be considered are: that plaintiff's super aircraft was subject to higher obsolescence than normally recognized with conventional cargo aircraft; that since the aircraft was developed on a limited budget of private capital and on a tight time schedule, the usual FAA commercial certification tests were not run and accordingly the craft could not be used for commercial cargo transportation after termination of the NASA contract; that certain operating limitations imposed by NASA created a special insurance risk; that record evidence indicates that flying the super aircraft was substantially more risky than flying conventional cargo aircraft; that new flight crews had to be trained and the ability of the super aircraft and new crews to perform without misshap was uncertain; that had the super aircraft been destroyed, NASA could have reverted to water transportation, whereas plaintiff would have lost the revenues generated by the craft; and that plaintiff operated under a firm, fixed-price contract under which it assumed full responsibility for its costs and bore the entire risk that costs might outrun the established contract price.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; factors to be considered; efficiency of contractor.

[16] In determining the amount of excessive profits, if any, realized

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by a sole-source supplier of air transportation services for NASA oversize shipments, favorable consideration should be given where the contractor met contract requirements, including delivery schedules, despite special operating limitations, including the need to avoid icing and turbulent conditions, making the craft exceptionally difficult to schedule; in this case, the quality of plaintiff's production is synonymous with meeting its production schedules; further, plaintiff was economical in use of materials, facilities, and manpower, and was otherwise effective in controlling production costs.

War and National Defense ⇐ 59

Renegotiation of contracts; evidence; relevant industrial statistics.

[17] Industrial statistics relevant to renegotiation are available in reliable and readily available sources.

War and National Defense ⇐ 59

Evidence; hearsay; admissibility of; market reports, commercial publications; renegotiation of contracts.

[18] In determining the amount of excessive profits, if any, realized by a Government defense contractor, corporate statistics of income published by the Internal Revenue Service and corporate financial reports of the FTC and SEC, *inter alia*, are within the hearsay exception and are acceptable evidence relevant to the factor of the contractor's net worth and capital employed.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; factors to be considered; net worth and capital employed.

[19] In determining the amount of excessive profits, if any, realized by a sole-source supplier of a unique air transportation service for NASA oversize shipments, without meaningful comparative data, with respect either to the contractor's own prior experience or to the experience of an industrial group demonstrated to have some relevance as a basis for comparison, the court has no yardstick with which to assess the net worth statutory factor. Like the rate of return on net worth, rate of return on capital employed is meaningful only in the context of relevant comparisons with the net worth and capital returns of other firms.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; factors to be considered; net worth and capital employed.

[20] As an abstract proposition a contractor performing a particular service with a given quantity of capital supplied only in part by itself, is entitled in renegotiation to less profit than a contractor which performs the same service with the same amount of capital completely provided by itself. However, absent evidence suggesting that the negotiated contract price included provision for

Syllabus

costs of borrowing working capital later made unnecessary by the Government's prompt reimbursement of plaintiff or evidence of what specific impact, if any, prompt payment had on plaintiff's profitability, the Government's prompt payment does not call for a finding that the Government supplied plaintiff's capital.

War and National Defense ⟸ 59

Renegotiation of contracts; redetermination of excessive profits; generally.

[21] Renegotiation is a system of variable profit rewards intended to recover excessive profits without impairing incentives for Government contractors to distinguish themselves by innovations and efficiency. A reasonable profit can be established only on a comparative basis because it is impossible to say what a particular product or service is intrinsically worth.

War and National Defense ⟸ 59

Renegotiation of contracts; redetermination of excessive profits; factors to be considered; reasonableness of costs and profits.

[22] In determining the amount of excessive profits, if any, realized by a Government defense contractor, reasonableness of the contractor's costs and profits must be determined on the basis of relevant comparisons which have varying degrees of probative weight depending upon how close they are demonstrated to be.

War and National Defense ⟸ 59

Renegotiation of contracts; redetermination of excessive profits; factors to be considered; extent of risk assumed.

[23] The amount of risk assumed by a contractor under a firm fixed-price contract depends upon how realistic his cost estimates are and upon the closeness of his pricing, the margin between the anticipated costs and the price set to cover costs and yield a profit.

War and National Defense ⟸ 59

Renegotiation of contracts; redetermination of excessive profits; factors to be considered; reasonableness of costs and profits; comparative data.

[24] In determining the amount of excessive profits, if any, realized by a sole-source supplier of a unique air transportation service for NASA oversize shipments, for the court to accept defendant's explanation of its failure to find relevant comparisons with plaintiff's costs and profits either in the air transportation or airframe manufacturing industry is to conclude that comparisons can never be made when a product or service is unique. 32 C.F.R. § 1460.2(c) does not take so limited a view of what comparative information is useful in renegotiation, but rather suggests the relevance of industry comparisons even when there is no identical product or service. In renegotiation, where the focus is upon profit opportunities rather than upon the existence or absence of marketplace

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competition, the relevant markets are the markets for capital investment, risk taking, and entrepreneurial skill.

War and National Defense ⇐ 59

Contracts; reasonable profit; weighted guidelines method.

[25] The weighted guidelines do not purport to be a retrospective technique for determining the overall reasonableness of a contractor's profits in a given fiscal year, but were designed primarily to aid contracting officers in negotiation.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; weighted guidelines method of determining reasonable profits.

[26] Although cost-plus-a-percentage-of-cost (CPPC) contracting is prohibited by Sec. 4(b) of the Armed Services Procurement Act of 1947, weighted guidelines survive the charge that they are a form of CPPC contracting when used prospectively as an aid in contract negotiation. However, use of a system based upon the weighted guidelines in renegotiation is fraught with danger. If a cost-based system of profit analysis were to be adopted by the court for renegotiation determination, contractors would be on notice that higher costs would yield the potential for greater allowable profits in renegotiation. A particular danger of applying any cost-plus method of profit analysis in renegotiation is that rewarding efficient performance is a basic imperative of renegotiation law, and, accordingly, the renegotiation process must be as free as possible from methods known to be detrimental to promotion of efficiency. Use of a weighted guidelines method in the subject renegotiation is suspect for a further reason; the procuring agency NASA has concluded that the weighted guidelines method is not suitable for NASA and its one-of-a-kind programs.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; factors to be considered; reasonableness of costs and profits; comparative data.

[27] Since the renegotiation regulations, Tax Court opinions, as well as scholarly comment emphasize the importance of making comparisons with a relevant industry in determining the amount of excessive profits, if any, and the reasonableness of costs and profits of a defense contractor, the Court of Claims can insist upon no less.

War and National Defense ⇐ 59

Renegotiation of contracts; redetermination of excessive profits; factors to be considered; reasonableness of costs and profits; depreciation.

[28] Tax rather than book depreciation is relevant for renegotiation purposes, absent special circumstances.

War and National Defense ⇐ 59

Francis C. Brown, Jr., attorney of record, for plaintiff.

Bruce G. Forrest, with whom was *Assistant Attorney General Rex E. Lee*, for defendant. *Gerald D. Freed*, of counsel.

Before COWEN, *Chief Judge*, DAVIS and KASHIWA, *Judges*.

PER CURIAM: This renegotiation case comes before the court on defendant's exceptions to the recommended decision, filed July 23, 1975, by Trial Judge Joseph V. Colaianni, pursuant to Rule 134(h), having been submitted on the briefs and oral argument of counsel. With the qualification to be stated in the next paragraph, the court agrees with the recommended decision, as hereinafter set forth,* and hereby affirms and adopts the same, with minor modifications, as the basis for its judgment in this case.

The court does not understand the trial judge's opinion as holding that use of the weighted guidelines method of determining reasonable profits (or a method patterned on that system) is automatically forbidden in renegotiation. That method is not outlawed *per se* if properly used** but, as the trial judge points out, it has some inherent dangers in assessing performance after the fact, which must be carefully guarded against. In this instance, defendant's expert witness did not so use the method, and perhaps could not in the circumstances, as to make a convincing presentation that plaintiff's profits were in fact excessive or to show the amount of the excess. The trial judge's opinion underscores the particular defects of the witness's presentation, and we agree with that criticism. The defendant has not carried the burden it bears, under *Lykes Bros. S.S. Co.* v. *United States*, 198 Ct. Cl. 312, 459 F. 2d 1393 (1972), of showing that plaintiff realized excessive profits and the amount of such excess.

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*Although the court adopts the trial judge's separate findings of fact, which are set forth in his recommended decision filed July 23, 1975, they are not printed herein since such facts as are necessary to the decision are contained in his opinion.

**Cf. *Newport News Shipbuilding & Dry Dock Co.* v. *United States*, 179 Ct. Cl. 97, 374 F. 2d 516 (1967); *Bethlehem Steel Corp.* v. *United States*, 191 Ct. Cl. 141, 423 F. 2d 300 (1970); *Bethlehem Steel Corp.* v. *United States*, 206 Ct. Cl. 122, 511 F. 2d 529, *cert. denied*, 423 U.S. 840 (1975).

Accordingly, plaintiff is entitled to a refund of the amount paid to defendant, together with interest as provided by the Renegotiation Act of 1951, as amended.

OPINION OF TRIAL JUDGE

COLAIANNI, *Trial Judge:* Plaintiff was a sole-source supplier to the National Aeronautics and Space Administration (NASA) of air transportation of "outsize" cargoes too large to be transported in conventional cargo aircraft. The cargoes which plaintiff transported for NASA consisted of components used in the Apollo Moon Program and included the Douglas Saturn-IV B Third Stage and North American Aviation's Lunar Excursion Module. Plaintiff transported these items from the west coast, where they were assembled, to Kennedy Space Center in Florida. To provide this unique service, plaintiff employed two specially fabricated aircraft known as the "Pregnant Guppy" and the "Super Guppy." Each had a substantially enlarged fuselage to accommodate the outsize NASA freight.

Plaintiff's contract with NASA was subject to the Renegotiation Act of 1951, 65 Stat. 7, *as amended*, 50 U.S.C. App. §§ 1211–33 (1970), *as amended*, (Supp. III, 1973). Dissatisfied with a unilateral determination by the Renegotiation Board that plaintiff realized excessive profits of $250,000 during fiscal year 1966, plaintiff seeks de novo judicial redetermination of the amount of excessive profits, if any, realized by plaintiff in 1966. The action was originally brought in the United States Tax Court and was transferred to the Court of Claims pursuant to the Act of July 1, 1971, Pub. L. No. 92–41, 3(e), 85 Stat. 97, 98 (1971).

Lykes Bros. S.S. Co. v. *United States*, 198 Ct. Cl. 312, 459 F. 2d 1393 (1972), established the principle that in de novo redeterminations by this court of the amount of excessive profits, if any, realized by a Government contractor subject to the Act, the burden rests upon the Government both to persuade the court that plaintiff realized excessive profits and to prove the extent of the excessive profits. The plaintiff does not have "the burden of persuasion on the principal issue" because plaintiff is, in effect, seeking declaratory relief from a unilateral assertion of the Renegotiation Board that plain-

tiff has realized excessive profits in a particular amount. *See id.* at 327, 328, 459 F. 2d at 1401, 1402. "It is the Government, based upon a unilateral order of the Renegotiation Board, which asserts that the contractor owes it money." *Id.* at 325, 459 F. 2d at 1400.

The Court of Claims is the first forum in which a contractor has an opportunity to be heard in a manner consistent with procedural due process and in a proceeding generating a formal, reviewable record. Accordingly, in the Court of Claims proceeding, no presumption of correctness is accorded the Renegotiation Board's order determining excessive profits. The unilateral order is treated simply as a claim by the Government against the contractor. Furthermore, the court held in the *Lykes* case, *supra*, that a rule assigning the burden of proving the existence and amount of excessive profits to the Government is more consistent with the Congressional requirement of a full de novo redetermination of excessive profits[1] than the former Tax Court practice placing upon the contractor the burden of proving that its profits were reasonable.[2] 198 Ct. Cl. 323–24, 330, 459 F. 2d at 1399, 1403. The Government bears this burden in a redetermination proceeding despite the fact that the contractor, as plaintiff, is nominally the moving party. For this reason, the court has found it helpful to analogize a renegotiation suit to the type of declaratory judgment action in which an insurer sues for a declaration relieving it of its contractual obligation to pay insurance benefits on the ground that actions of the insured, such as suicide, have made the policy inapplicable. Although such a suit is instituted by the insurer,

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[1] 50 U.S.C. App. § 1218 (1970), *as amended*, (Supp. III, 1973).

[2] In *Renegotiation Board* v. *Bannercraft Clothing Co.*, 415 U.S. 1, 23 (1974), the first of two recent decisions dealing with the relationship between the Renegotiation Act and the Freedom of Information Act, the Supreme Court made the following reference to renegotiation suits in this court:

"There is no limitation or denial of the contractor's normal litigation rights when the renegotiation process is at end. The contractor may institute its *de novo* proceeding in the Court of Claims, *unfettered by any prejudice from the agency proceeding* and free from any claim that the Board's determination is supported by substantial evidence. There the usual rights of discovery are available. And there *the parties are not bound by a prior determination made at any level of the Renegotiation Board structure.*" [Emphasis added; footnote omitted.]

which has "the burden of providing the existence of the controversy" [3] and the jurisdiction of the court,—[4]

> * * * the burden of proving, by a fair preponderance of the evidence, the existence of the fact or facts upon which the rights and liabilities of the parties depend is upon him who has the affirmative of the issue which forms the basis of the controversy, without regard to whether he is plaintiff or defendant in the suit.[5]

In an insurance declaratory judgment action, the party held to have "the affirmative of the issue which forms the basis of the controversy" is the representative of the insured, who must prove that the claim for recovery under the insurance policy is a valid one. In a renegotiation suit, the underlying claim is the Government's assertion that the contractor realized a particular quantity of excessive profits. In both types of cases, the party asserting the fundamental claim has the burden of proof. The analogy between the insurance declaratory judgment and de novo redetermination of excessive profits in this court is central to the court's opinion in *Lykes*. 198 Ct. Cl. at 328–29, 459 F. 2d at 1402.

By assigning the burden of persuasion to the Government, the court also held that the Government, although the defendant, must bear the risk of nonpersuasion if the evidence in the case should be in equipoise. In an action patterned on the insurance declaratory judgment model, "* * * the burden of proof is on the party who would receive an adverse judgment if no evidence were submitted." Annot., 23 A.L.R. 2d 1243, 1253 (1952), citing *Reliance Life Ins. Co.* v. *Burgess*, 112 F. 2d 234 (8th Cir.), *cert. denied*, 311 U.S. 699 (1940), *Bauer* v. *Clark*, 161 F. 2d 397 (7th Cir.), *cert. denied*, 332 U.S. 839 (1947), and *Pacific Portland Cement Co.* v. *Food Mach. & Chem. Corp.*, 178 F. 2d 541 (9th Cir. 1949).

Although the Government bears the risk of nonpersuasion, a risk which, once it is assigned, does not shift during the course of litigation, the court held, in the exercise of its dis-

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[3] *Reliance Life Ins. Co.* v. *Burgess*, 112 F. 2d 234, 240 (8th Cir.) (concurring opinion), *cert. denied*, 311 U.S. 699 (1940), cited with approval in *Lykes Bros. S.S. Co.* v. *United States*, 198 Ct. Cl. 312, 328–29, 459 F. 2d 1393, 1402 (1972).

[4] E. BORCHARD, DECLARATORY JUDGMENTS 407 (2d ed. 1941).

[5] *Reliance Life Insurance Co.* v. *Burgess*, *supra*, 112 F. 2d at 241.

cretion over the manner in which its proceedings are to be held, that—

> * * * the contractor has the initial burden of going forward with proof as to the statutory factors upon which it relies to the extent that the facts pertaining thereto are within its knowledge or possession, are accessible to the public generally in the form of published reports, or are *actually made available to the contractor* by the Government, * * *. Normally, when the contractor does this, it will have made a prima facie case, i.e., a showing which, unless rebutted, would justify a judgment in accord with the contractor's contentions.[6]

The rule adopted by the court is analogous to a Renegotiation Board Regulation, 32 C.F.R. § 1460.1, "General Considerations," which provides:

> (b) The contractor will be given an opportunity to develop and present whatever information is available to it *which the contractor may consider pertinent to the determination.* [Emphasis added.]

During the Board proceedings, the contractor is given an opportunity to present information which it feels places its contribution in the most favorable light, before the Board reaches its conclusion concerning the contractor's profitability. *See Renegotiation Board* v. *Grumman Aircraft*, 421 U.S. 168, 173–74, 175, 176–77 (1975).

Similarly, by holding that the contractor may discharge its burden of going forward by presenting evidence as to the statutory factors *upon which it relies*, the court has defined the contractor's task as making the best case it can to blunt the impact of the defendant's anticipated case in chief. Plaintiff's obligation to proceed first is not an empty formality. Though defendant bears the risk of nonpersuasion regardless of the cogency of plaintiff's opening presentation, plaintiff's opening case will inevitably influence the outcome of the litigation by determining how easily defendant can meet its burden of persuading the court that plaintiff realized excessive profits in a particular amount. If its opening presentation is cogent and thorough, plaintiff runs less risk

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[6] *Lykes Bros. S.S. Co.* v. *United States, supra,* 198 Ct. Cl. at 326–27, 459 F. 2d at 1401.

that the Government will be able to overcome that presentation in seeking to meet its burden of persuasion. On the other hand, if plaintiff's initial presentation is perfunctory, defendant's chance of success is much greater. Obviously, plaintiff's rebuttal case would be strictly confined to meeting defendant's affirmative arguments.

In his dissenting opinion in *Bannercraft Clothing Co.* v. *Renegotiation Board*, 466 F. 2d 345 (D.C. Cir. 1972), *rev'd.*, 415 U.S. 1 (1974), Judge MacKinnon discussed the importance of the new ground rules adopted by this court in the *Lykes* decision for protecting the rights of Government contractors undergoing renegotiation:

> The Court of Claims replaced the United States Tax Court as the forum for review of "final determinations" of the Renegotiation Board on July 1, 1971. One of the reasons given in the legislative history for this transfer of jurisdiction was that the Court of Claims is procedurally more suitable for handling renegotiation cases than the Tax Court. H.R. Rep. No. 92–235, 92d Cong., 1st Sess. 6 (1971). *Lykes* is the first renegotiation case to have been decided in the Court of Claims since the transfer, and the congressional prophecy seems about to be fulfilled. In *Lykes* * * * the burden of proof concerning the existence and extent of excess profits was shifted to the Government. Perhaps more significantly in the context of our cases here, the burden of going forward with evidence with regard to the statutory factors on which the contractor relies in his argument against an excess profit finding remains with the contractor, but only
>
> > to the extent that the facts pertaining thereto are within its knowledge or possession, are accessible to the public generally in the form of published reports, or are *actually made available to the contractor* by the Government, voluntarily through a request made in pre-trial proceedings, by discovery under the rules of the court, or pursuant to the Freedom of Information Act, 5 U.S.C. § 552.

Id. at 367.

For reasons discussed *infra*, plaintiff, Aero Spacelines, Inc., had made a prima facie showing that it did not realize excessive profits in 1966. The Government has failed to demon-

strate by a preponderance of the evidence either that plaintiff's profits during 1966 were excessive or the amount of the alleged excess.

Stipulated Cost Figures will be Used

As a preliminary matter, plaintiff contends that costs not reflected on the books and records of Aero Spacelines, Inc., or in the accounting statement to which the parties stipulated before trial should be recognized by this court in order properly to state the costs incurred by plaintiff in connection with its renegotiable business. Specifically, plaintiff asks for:

> 1. An adjustment of $95,244 in "unreflected depreciation" to compensate plaintiff for the fact that no depreciation was taken on the "Super Guppy," one of the aircraft employed by plaintiff, during the first 2 months of 1966 while the Super Guppy was still undergoing flight tests;
> 2. A credit for an undetermined "reserve for self-insurance" to compensate plaintiff "to the extent that plaintiff either elected or was compelled to act as a self-insurer with respect to certain risks"; and
> 3. A $950,000 cost allowance to reflect amortization of the excess of the purchase price Aero Spacelines, Inc., paid for its assets over the value of those assets on the books of Havenhurst Van Nuys, Inc., the corporation which was plaintiff's predecessor.

For reasons which follow, each of these cost adjustments proposed by plaintiff is rejected. The sales, cost, and profit figures to be assayed for excessiveness are those to which the parties stipulated before trial.

The parties stipulated that plaintiff had $3,926,239 in renegotiable sales; $2,793,299 in costs attributable to those sales; and $1,132,940, the difference between sales and costs, in renegotiable profits. Plaintiff now argues that additional costs, neither reflected upon plaintiff's books nor included in the accounting statement to which the parties stipulated, should nevertheless be taken into account. Plaintiff seeks thereby to reduce the $1,132,940 profit figure to which the parties have agreed.

The stipulation of facts incorporates by reference, with two exceptions not material here, the statement on accounting

for renegotiation submitted as plaintiff's first exhibit.[7] The stipulation has the effect of adopting the accounting figures of the statement on accounting for renegotiation which put plaintiff's renegotiable sales, costs, and profit at $3,926,239, $2,793,299 and $1,132,940, respectively. By express terms of the stipulation, these figures were not to be subject to contradiction by additional, conflicting facts. By asking the court to recognize additional costs, which would correspondingly reduce plaintiff's profits, plaintiff proposes to do precisely what the terms of the stipulation prohibit.

Although the court will occasionally relieve a party of its stipulation "if necessary to prevent an injustice, particularly where facts contrary to the stipulation are established by the evidence," *H. B. Zachry Co.* v. *United States*, 170 Ct. Cl. 115, 123, 344 F. 2d 352, 357 (1965), the general rule is that absent special considerations, parties are bound by their stipulation on issues of fact. *Gresham & Co.* v. *United States*, 200 Ct. Cl. 97, 112–13, 470 F. 2d 542, 551 (1972); *John McShain, Inc. v. United States*, 179 Ct. Cl. 632, 635, 375 F. 2d 829, 831 (1967). Analysis of the substance of plaintiff's three proposed additions to cost indicates this is not an appropriate occasion for deviating from this rule.

Plaintiff's first cost adjustment proposal is that $95,244 be added to compensate plaintiff for its failure to take depreciation on the Super Guppy during the first 2 months of 1966. Depreciation of plaintiff's aircraft was allowable as a cost of plaintiff's performance of air transportation services for NASA. During 1966, plaintiff was permitted for tax purposes to use a 5-year depreciable life for the Super Guppy and a 200 percent declining balance method of depreciation. Given a book basis of $1,714,395 for the Super Guppy and the method of amortization just described, plaintiff would have been entitled to take $685,758, or 40 percent of the book value of the Super Guppy as tax depreciation during calendar year 1966. However, since the Super Guppy was still undergoing tests in January and February 1966 and had not begun transporting NASA

[7] A third item, purporting to resolve a difference between the parties by stipulating a 5-year depreciation period for plaintiff's Super Guppy aircraft, was superfluous, having already been taken into account in plaintiff's accounting submission.

cargoes under plaintiff's contract with NASA, plaintiff did not begin depreciating the aircraft until the beginning of March. The actual depreciation taken during the 10 months of 1966 when the Super Guppy was used for actual air transportation was $571,465. This is 10/12 of the first-year amortization of the Super Guppy. Plaintiff seeks now both to overturn the stipulation between the parties, which specified $571,465 as the amount of depreciation actually taken on the Super Guppy, and the accounting procedure which plaintiff in fact used in 1966. This it may not do.[8]

Plaintiff argues that the court has discretion, which it should exercise here, to allow an additional $95,244 in Super Guppy depreciation for the first 2 months of 1966. To support its position, plaintiff invokes section 103(f) of the Renegotiation Act of 1951, 50 U.S.C. App. § 1213(f) (1970), *as amended*, (Supp. III, 1973). That part of the renegotiation statute provides that "All items estimated to be allowed as deductions and exclusions under chapter 1 of the Internal Revenue Code" shall be allowed as items of cost for renegotiation purposes. Section 1213(f) also confers upon this court discretion to redefine costs, but only in situations in which a contractor either has not employed a regular method of accounting or has employed a method which does not properly reflect the contractor's cost of doing renegotiable business.

Plaintiff employed an established cost accounting method for 1966. Accordingly, in order to persuade the court to use its statutory authority to modify plaintiff's chosen method of accounting, plaintiff must demonstrate that the method actually used does not properly reflect plaintiff's costs.[9]

This is not such a situation. Plaintiff has shown no facts of record to suggest that use of the standard accounting

[8] If plaintiff's contention that it should be allowed to make a retroactive adjustment for depreciation not taken during the first 2 months of 1966 were sustained, the correct amount of the adjustment would not be $95,244 or 2/12 of $571,465, as contended by plaintiff, but rather $114,293, which is 2/12 of $685,758, the full annual depreciation amount computed by the double declining balance method.

[9] *See Bay Co.* v. *Renegotiation Board*, 38 T.C. 535, 546–48 (1962), in which a contractor's evidence that other accounting methods would have been more accurate was not considered by the Tax Court where the method actually employed did accurately reflect costs. *See also* 32 C.F.R. § 1459.1(b)(2) (1974) (Renegotiation Board regulation).

principle that property is depreciated over its useful life would cause plaintiff's costs to be misstated. Plaintiff did not depreciate the Super Guppy in January or February of 1966 because the aircraft was still undergoing tests. The Super Guppy did not actually begin carrying NASA cargoes until March 1966.

A principal advantage of consistent adherence to Internal Revenue Code accounting methods, mandated by Congress in 50 U.S.C. App. § 1213(f) (1970), *as amended*, (Supp. III, 1973), is the uniformity which those methods provide over several years of renegotiable business. Defendant correctly observes that the depreciation which plaintiff now seeks to take was undoubtedly reflected in plaintiff's tax returns and renegotiation reports for subsequent years.[10] In order to prevent a "double deduction" of the additional $95,244 depreciation allowance now sought by plaintiff, revision of all of plaintiff's subsequent tax and renegotiation submissions would be necessary. Plaintiff has not shown the manifest unsuitability of the accounting method it has used which might warrant revision of that method, with all of the attendant complications.

Plaintiff's second proposed cost adjustment is for a "reserve for self-insurance," unspecified in amount and not reflected in plaintiff's accounting statement to which the parties have agreed. Plaintiff carried hull, liability, and excess liability insurance on its aircraft during 1966 and loss of use insurance for the first 6 months of 1966. Plaintiff argues that it should receive an indeterminate amount of cost credit for the extent to which it acted as a self-insurer with respect to losses not covered by insurance and for which it had no recourse to NASA. Plaintiff set aside no reserve for self-insurance against possible loss of use or any other contingency in 1966, and no such reserve appears in plaintiff's accounting statement. Accordingly, there is no basis in fact for this court to make the cost adjustment which plaintiff seeks.

The third cost adjustment sought by plaintiff is a $950,000 cost allowance to reflect amortization of the excess of the pur-

[10] In fact, the record shows that plaintiff did depreciate the Super Guppy fully, down to a token salvage value of $50,000.

chase price which was paid for the assets of Havenhurst Van Nuys, Inc. To place plaintiff's argument in context, it is necessary to know something of plaintiff's organizational history.

Plaintiff, Aero Spacelines, Inc., was organized in 1965 as a wholly-owned subsidiary of Twin Fair, a New York corporation, to acquire the assets and assume the liabilities of Havenhurst Van Nuys, Inc., a California corporation known also as Aero Spacelines, Inc.

Prior to being acquired, Havenhurst had designed and fabricated at its sole expense and risk a special purpose aircraft for transporting outsize cargo by air. This aircraft, known as the Pregnant Guppy, was a structurally modified Boeing 377 Stratocruiser. Havenhurst conceived and developed the Pregnant Guppy and proved its capability to transport oversize cargoes. From its completion in mid-1963, the Pregnant Guppy was continuously under exclusive contract to NASA.

In January 1965, Havenhurst began modifying a Boeing YC–97J aircraft to transport cargoes that were too large even for the Pregnant Guppy. These cargoes included the Saturn-IV B stage and the Lunar Excursion Module. This second structurally modified Boeing aircraft was designated the Super Guppy. The Super Guppy was not simply an extension of the technology of the Pregnant Guppy, which had been built by enlarging the fuselage of the Boeing 377 Stratocruiser. Manufacture of the second Guppy aircraft required numerous, complex modifications of the YC–97J. These modifications were considerably more elaborate than those which were necessary in manufacturing the Pregnant Guppy.

By mid-1965, Havenhurst found itself financially unable to complete construction of the Super Guppy. Havenhurst was insolvent, had exhausted its credit, and was seeking a purchaser willing to provide the financing necessary to complete construction of the Super Guppy. The management of Twin Fair was approached by a business broker who suggested that Twin Fair acquire the assets of Havenhurst.

On August 12, 1965, before completion of the Super Guppy and prior to the beginning of the fiscal year under considera-

tion, Havenhurst transferred all of its assets (including its NASA contract) and liabilities to plaintiff, Aero Spacelines, Inc., in exchange for voting common stock of Twin Fair, plaintiff's parent corporation. The parties have stipulated that the purchase price exceeded the value of the net assets on the books of the acquired corporation by at least $2,185,340. No portion of this excess was amortized or otherwise charged against the contractor's sales in determining profits subject to renegotiation. There is no evidence that the acquisition price negotiated was not arrived at by arm's-length dealings between the acquired and acquiring corporations.

The acquisition qualified under Section 368(a)(1)(C) of the Internal Revenue Code of 1954 as a tax-free reorganization. The principal tax consequences of treating the acquisition as a tax-free reorganization were two-fold:

> 1. Havenhurst was not required to recognize capital gains upon the transaction (INT. REV. CODE OF 1954, § 361(a)); and
> 2. The basis of the property transferred to Aero Spacelines, Inc., remained the same as it had been in the hands of the transferor (INT. REV. CODE OF 1954, § 362(b)).

Consistent with Section 362(b) of the Code, the Havenhurst assets were taken on the tax books of the new corporation, Aero Spacelines, Inc., at their depreciated value on the tax books of Havenhurst. The market value of the Twin Fair stock issued in exchange for the assets was not shown on the Aero Spacelines' books. Accordingly, none of the difference between the market value of the Twin Fair stock and the depreciated tax value of the Havenhurst assets was amortized against the contractor's sales in determining profit subject to renegotiation.

In seeking to amortize the stipulated excess of the purchase price over the tax book value of Havenhurst assets acquired by Aero Spacelines, Inc., plaintiff now attempts to modify the accounting method which it actually used in 1966 for federal income tax purposes. To do this, plaintiff must demonstrate that the method used for federal income tax purposes is manifestly unsuitable for renegotiation purposes because it does not clearly reflect the profits attributable to plaintiff's performance of its renegotiable contract in 1966.

The plaintiff must show, further, that the alternative it proposes does clearly reflect such costs. This plaintiff has not done.

Plaintiff argues that under presently accepted accounting principles applicable to its nontax bookkeeping, the stipulated $2,185,340 difference between the market value of Twin Fair stock issued to acquire the Havenhurst assets and the book value of the acquired assets would be reflected on the books and records of the plaintiff and amortized against earnings. This would result in a charge against earnings in 1966 in an amount in excess of $900,000.[11]

This $2,185,340 component of the purchase price, plaintiff asserts, was a true economic cost of the acquisition and, accordingly, should be recognized by this court in evaluating plaintiff's costs.

At trial, plaintiff introduced evidence that under presently accepted accounting principles the August 1965 acquisition would be required to be accounted for by the "purchase method." In this form of combination—

> * * * [t]he agreed terms * * * recognize primarily the fair values and only secondarily the historical-cost based amounts of assets and liabilities as reflected in the financial statements of the acquired company. Accordingly, the purchase method requires recognition of the fair values through allocation of the cost or purchase price of an acquired company to the assets acquired and liabilities assumed. Identifiable assets and liabilities of an acquired company, whether or not shown in the financial statements of that company, are assigned a portion of the purchase price, normally equal to their fair values at date of acquisition. Any excess of the purchase price over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed is recorded as goodwill. Goodwill is required to be amortized by systematic charges to income over the period estimated to be benefited.

Despite its superficial appeal, plaintiff's argument fails for two reasons. First, the "purchase method" of accounting was not actually used in 1965 by the parties to the acquisition. They elected instead, in accordance with then gen-

[11] At trial, plaintiff's president, Mr. Vaughan Read, placed the 1966 amortized portion of this excess at $950,000.

erally accepted accounting principles, to treat the transaction as a "pooling of interests." Paragraph 12 of Opinion No. 16 of the Accounting Principles Board (August 1970), which applies primarily to nontax accounting procedures, explains that in a pooling of interests—

> * * * [o]wnership interests continue and the former bases of accounting are retained. The recorded assets and liabilities of the constituents are carried forward to the combined corporation at their recorded amounts.

In 1966, this method was used for most business combinations in which stock was issued. It was the method actually used by plaintiff, was reflected in plaintiff's 1966 nontax books, and closely paralleled the tax accounting method mandated by Sections 361 and 362 of the Internal Revenue Code for a tax free reorganization.

Plaintiff's accounting witness testified that if the transaction had taken place in 1974 rather than in 1965, the preferred accounting approach would be the purchase method rather than the pooling of interests method. However, the witness noted specifically that by its express terms, Accounting Principles Board Opinion No. 16 was not to be applied retroactively to business combinations initiated before November 1, 1970, the effective date of the opinion. The witness testified, further, that it was neither his opinion nor the opinion of Price Waterhouse, the accounting firm which he represented, that the change in method should be applied retroactively in this case.

Secondly, retroactive application of the purchase method presents difficult problems of valuation which plaintiff has not addressed with proof. Plaintiff has not assigned fair values to the "identifiable assets" acquired from its predecessor. No portion of the purchase price has been assigned to a 5-year covenant of the officers of plaintiff's predecessor not to compete with Aero Spacelines in the outsize cargo air transportation business. No fair value has been assigned to the NASA contract to which the new corporation was to succeed. Since plaintiff has made no attempt to assign portions of the purchase price to the identifiable assets received from Havenhurst, it is not possible to place a value on the residual, the goodwill acquired from Havenhurst. Plaintiff

has neither estimated the period to be benefited by Havenhurst's goodwill [12] nor addressed the troublesome question of why, even if annual goodwill amortization could be measured, the Government should subsidize plaintiff's acquisition of a concern with potential commercial viability well after expiration of the exclusive NASA contract under which plaintiff initially operated. Because plaintiff has not allocated specific portions of the $950,000 annual amortization cost claimed to increases in the values of physical assets over book values, to plaintiff's intangible assets (the covenant not to compete and the NASA contract), or to goodwill, plaintiff has failed to make the clear factual presentation necessary to warrant replacing the method of accounting plaintiff actually used in 1966 and to which the parties have stipulated.

I. *Plaintiff's Prima Facie Case*

Lykes Bros. S.S. Co. v. *United States* charges the contractor with the initial burden of going forward with proof as to the statutory factors upon which it relies in order to make a prima facie case that it has not realized excessive profits in the year under review. 198 Ct. Cl. at 326–27, 459 F. 2d at 1401. Once the contractor has done this, "the burden shifts to the Government to prove that plaintiff's profits were excessive and the extent thereof." *Id.* at 327, 459 F. 2d at 1402. The Government has the burden of persuasion on each of these issues. *Id.*

In § 103(e) of the Renegotiation Act of 1951, 50 U.S.C. App. § 1213(e) (1970), Congress set forth the following, general criteria for identifying "excessive profits":

> The term "excessive profits" means the portion of the profits derived from contracts with the Departments

[12] The principal obstacle to the allowance of charges against income for amortization of goodwill is the difficulty of establishing a useful life. *See Thrifticheck Serv. Corp.* v. *Commissioner*, 287 F. 2d 1, 4–5 (2d Cir. 1961), in which the price paid by a purchaser of a business for intangibles was held nondepreciable for lack of any reasonable estimate of useful life. *See also Golden State Towel & Linen Serv., Ltd.* v. *United States*, 179 Ct. Cl. 300, 305, 373 F. 2d 938, 941 (1967); *Meredith Broadcasting Co.* v. *United States*, 186 Ct. Cl. 1, 30, 405 F. 2d 1214, 1230–31 (1968); *KFOX, Inc.* v. *United States*, 206 Ct. Cl. 143, 166, 510 F. 2d 1365, 1377–78 (1975).

and subcontracts which is determined in accordance with this title [sections 1211 to 1224 of this Appendix] to be excessive. In determining excessive profits favorable recognition must be given to the efficiency of the contractor or subcontractor, with particular regard to attainment of quantity and quality production, reduction of costs, and economy in the use of materials, facilities, and manpower; and in addition, there shall be taken into consideration the following factors:

(1) Reasonableness of costs and profits, with particular regard to volume of production, normal earnings, and comparison of war and peacetime products;

(2) The net worth, with particular regard to the amount and source of public and private capital employed;

(3) Extent of risk assumed, including the risk incident to reasonable pricing policies;

(4) Nature and extent of contribution to the defense effort, including inventive and developmental contribution and cooperation with the Government and other contractors in supplying technical assistance;

(5) Character of business, including source and nature of materials, complexity of manufacturing technique, character and extent of subcontracting, and rate of turn-over;

(6) Such other factors the consideration of which the public interest and fair and equitable dealing may require, which factors shall be published in the regulations of the Board from time to time as adopted.

As the Supreme Court noted in *Lichter* v. *United States*, 334 U.S. 742, 784–85 (1948), Congress did not choose to provide the Renegotiation Board or the courts—

> * * * with a specific formula for their guidance in a field where flexibility and the adaptation of the congressional policy to infinitely variable conditions constitute the essence of the program.

Congress' eschewal of formulae or precise percentage limitations on profits was deliberate, renegotiation having been conceived as a flexible means of eliminating excessive profits without interference with war production.[13] The need for case-by-case application of the statutory factors

[13] *See* R. C. Osborn, Renegotiation of War Profits 82 (University of Illinois Bureau of Economics and Business Research Bulletin No. 67, 1948).

was made necessary by the difficulty of developing broad rules which could be applied fairly to all types of firms doing business with the Government,[14] and determinations of excessiveness made on the basis of individual cases were designed to eliminate problems presented by use of a fixed-profit formula.[15] 32 C.F.R. § 1460.8(a) (1974) provides:

> Reasonable profits will be determined in every case by over-all evaluation of the particular factors present and not by the application of any fixed formula with respect to rate of profit, or otherwise.

This Renegotiation Board regulation underscores the importance of comprehensive evaluation, in terms of all of the statutory factors, of a renegotiated contractor's performance in the fiscal year under review.

"Comprehensive evaluation" is not synonymous with purely subjective determination. As the Tax Court observed in *LTV Aerospace Corp.* v. *Renegotiation Board*, 51 T.C. 369, 397 (1968), one of the last cases in which that court addressed the specific issue of excessive profits,—

> The decision as to the existence and amount of excessive profits is to be reached on the basis of objective business judgment [citing H. REP. No. 7, 82d Cong. 1st Sess. 2 (1951)], and the Act provides a number of criteria to be considered in making that judgment.

Although the criteria are necessarily general and though the different statutory factors necessarily have different weight and relevancy in different situations,—

> * * * The parties to a renegotiation proceeding must present to this Court the facts relevant to the contractor's performance. They must also present sufficient information as to the relevant industry norms to enable this Court to determine the appropriate standards against

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[14] Weston & Jacoby, *Profit Standards*, 66 Q. J. ECON. 224, 227–28, 248–49 (1952).

[15] Three major objections to flat profit limitations by Congress were that such limitations provided no incentive to reduction of costs, failed to reward efficiency, and failed to achieve true uniformity by rewarding Government contractors in accordance with the complexity of their performance, magnitude of their risk and extent of their contribution to the defense effort. Statement of Robert C. Patterson, Under Secretary of War, *Hearings on Sec. 403 of Public Law Numbered 528 Before a Subcomm. of the Senate Comm. on Finance*, 77th Cong., 2d Sess. 5, 7, 10–11 (1942).

> which the contractor's performance under each criterion is to be evaluated. Finally, they must provide us with sufficient information that we may determine what weight the contractor's comparative performance under each criterion is to be given, in the particular case, in reaching our ultimate decision. [*Id.*]

Though the *Lykes* decision shifted the burden of persuasion on the issue of excessiveness from the contractor, upon whom it had rested in proceedings before the Tax Court, to the Government, *Lykes* did not dispense with the requirement that the court have enough information before it to render a just decision. The court must be in the position to make a decision based upon reasoning cogent enough—

> * * * to warrant the conclusion that any reasonable and fairminded man, exercising an informed business judgment, would be likely to reach approximately the same result.[16]

Insistence by the Tax Court in *LTV Aerospace Corp.* v. *Renegotiation Board*, *supra*, on meaningful comparative data is echoed by 32 C.F.R. § 1460.2(c) (1974), which provides:

> *Comparisons.* In evaluating the contractor's performance, comparisons will be made with the prices, costs and profits of other contractors engaged in the production of the same or similar products or using the same or similar processes.

Comparative analysis is essential in order to give the statutory factors concrete, dollars and cents meaning.

In the words of one commentator on renegotiation:

> The term [excessive profits] itself implies comparisons to profits earned on current and previous private con-

[16] GAO, REPORT TO CONGRESS: OPERATIONS AND ACTIVITIES OF THE RENEGOTIATION BOARD 33 (GAO Report B-163520, 1973), *quoting* Renegotiation Board Operational Bulletin 60-14. This objective, first articulated in the Renegotiation Board operating bulletin, is an appropriate one to insist upon here. A similar goal was articulated in H. FRIENDLY, THE FEDERAL ADMINISTRATIVE AGENCIES: THE NEED FOR BETTER DEFINITION OF STANDARDS 14 (1962):

"[W]here the initial standard is thus general, it is imperative that steps be taken over the years to define and clarify it—to canalize the broad stream into a number of narrower ones. I do not suggest this process can be so carried out that all cases can be determined by computers; I do suggest it ought to be carried to the point of affording a fair degree of predictability of decision in the great majority of cases and of intelligibility in all."

> tracts by both the contractor and its competitors and profit earnings averages for the relevant industry.[17]

A most important question in renegotiation is "* * * where the contractor in a defense industry belongs in the hierarchy of profit returns of industry as a whole and the reason for his being placed in that particular position." [18]

Despite the importance of meaningful comparative data, neither party to this suit has made a significant effort to bring such information before the court. The absence of helpful comparisons characterized both plaintiff's prima facie case and the Government's response. The defendant, which bears the ultimate burden of proving both the existence of excessive profits *and the extent of those profits* necessarily fares worse than does plaintiff for lack of this information.

Character of Business

The fifth, enumerated statutory factor, "character of business," is discussed first in order to provide a framework for discussion of all of the statutory factors. The language of Section 103(e)(5), 50 U.S.C. App. § 1213(e)(5) (1970), is as follows:

> (5) Character of business, including source and nature of materials, complexity of manufacturing technique, character and extent of subcontracting, and rate of turn-over;

During fiscal year 1966, plaintiff provided oversize air transportation services for the National Aeronautics and Space Administration pursuant to renegotiable contract NAS 8-15476. In addition, plaintiff performed instrument calibration and maintenance and engine overhaul and modification projects related to the basic transportation service

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[17] Note, *Reform of the Renegotiation Process in Government Contracting*, 39 GEO. WASH. L. REV. 1141, 1162 (1971). This view is echoed in both governmental and scholarly discussion of the renegotiation process. *See, e.g.*, STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 93D CONG., 2D SESS., STAFF REVIEW OF RECOMMENDATIONS MADE ON THE RENEGOTIATION PROCESS: A PRELIMINARY REPORT 28 (1974); Weston & Jacoby, *supra* note 14; Burns, *The Tax Court and Profit Renegotiation*, 13 J. L. & ECON. 307, 312 (1970); Marcus, *The Need for Standards in Renegotiation and Other Determinations of Defense Profits*, 32 GEO. WASH. L. REV. 23 (1963).

[18] Marcus, *supra* note 17, at 47.

contract. Plaintiff's renegotiable sales of $3,926,239 accounted for all but less than one-tenth of one percent of plaintiff's total business in 1966. Plaintiff's nonrenegotiable sales consisted of a single $3,300 sale of surplus equipment. Plaintiff's nonrenegotiable sales are of no significance for renegotiation purposes because they constituted such a minimal fraction of plaintiff's total business.

As noted earlier in this opinion, plaintiff used two specially built aircraft to carry cargoes for NASA which were simply too large for conventional cargo aircraft to accommodate. The first of these aircraft, the Pregnant Guppy, had been developed by Havenhurst, plaintiff's predecessor corporation, and had been continuously under exclusive contract to NASA since its completion in mid-1963. The second, larger and more complex aircraft, the Super Guppy, was begun by Havenhurst but was completed and flight tested by plaintiff after plaintiff purchased its insolvent predecessor in order to continue its operations.

Both of the Guppies—but particularly the Super Guppy, which plaintiff completed and tested—were extraordinary looking aircraft whose unconventional profiles appeared almost to defy the laws of aerodynamics. The Pregnant Guppy had been fabricated by enlarging the fuselage of a Boeing 377 Stratocruiser to 19 feet 9 inches in diameter by building a new shell around the old fuselage. No further structural changes were required in order to maintain the aerodynamic stability of the aircraft. Manufacture of the Super Guppy, however, was considerably more complex.

The Super Guppy was designed principally as a mode of transportation for Douglas S–IVB stages, which were used as the third stage of the NASA Saturn-V launch vehicle employed in the Apollo moon program. The Super Guppy began with a Boeing YC–97J, a military cargo aircraft which had the additional power needed to carry the heavier cargoes envisioned for the Super Guppy. Only two YC–97J's had ever been manufactured, and one of these had already been scrapped by the Air Force. To accommodate the S–IVB stage, the fuselage of the Super Guppy had to be expanded to between 23 and 24 feet in diameter. This change in fuselage dimensions so altered the aerodynamic characteristics of the

Super Guppy from those of the YC–97J that significant modifications to the wing and tail structures were also required. The YC–97J was, in effect, completely dismantled and reassembled into an entirely new aircraft.

Aero Spacelines also made significant structural changes related to the cargo loading capability of the Super Guppy. The Super Guppy was the first aircraft ever to be built with a nose opening for loading cargo. The flight control system of the aircraft also had to be redesigned so that the nose could be hinged open. The control system's modification was a major one and the first of its kind.

The United States Government provided none of the capital for development of the Super Guppy airframe, and Havenhurst was the only business known to NASA which was willing to design and build such an aircraft at its own risk and expense. After Aero Spacelines "bailed out" the insolvent Havenhurst, the new corporation obtained a $950,000 loan from a New York bank, guaranteed by the parent company, in order to complete construction of the Super Guppy.

Contract NAS 8–15476 was not a manufacturing contract nor a contract for purchase of aircraft, but was a service contract providing transportation of oversize cargo. NAS 8–15476 was unique among service contracts in that the Guppies were both designed for the purpose of facilitating the NASA space program and with particular NASA cargoes in mind. This was especially true of the Super Guppy, whose internal dimensions were determined in large measure by the dimensions of the S–IVB stage, a specific item of NASA freight. Furthermore, contract NAS 8–15476 specified that NASA should have exclusive use of the services of the Guppies for the duration of the contract, including renewal periods, and NASA insisted vigorously upon keeping the aircraft under its control.

The unusual character of plaintiff's business, and plaintiff's willingness to design and build a special purpose aircraft at its own risk and expense, are important factors in establishing plaintiff's prima facie case.

The statutory subfactor, complexity of manufacturing technique, is not applicable because plaintiff provided a serv-

ice. The difficulties inherent in plaintiff's operations are considered under the statutory factors, "risk" and "contribution to the defense effort."

Source and nature of materials is a second subfactor to be considered under the statutory factor, "character of business." Pursuant to two Air Force contracts, the Air Force leased to plaintiff spare aircraft parts, aircraft engines, and propellers for use in operating the Super Guppy. These Government surplus items had a total "stated value" of $1,424,476. Defendant's witness testified that "stated value" is undepreciated original cost to the United States, it being the practice of the Government not to depreciate its equipment but to write off the cost only when the equipment is scrapped. No evidence appears in the record to establish what it would have cost plaintiff to purchase these materials had plaintiff been required to purchase them. By the terms of the Air Force contracts, plaintiff was obligated to maintain the equipment at its own expense and to return it to the United States Air Force in the same condition as received, less normal wear and tear. Plaintiff paid no fee for the use of these surplus items.

32 C.F.R. § 1460.14(b)(2) (1974) provides:

> A contractor who uses customer-furnished materials *generally* is not entitled to as large a dollar profit as the dollar profit to which such contractor would have been entitled had it furnished the materials itself. In the latter case, the contractor would have expended effort in finding or acquiring the materials, would have invested capital in the materials and would have assumed the risks of obsolescence, spoilage, or other loss inherent in owning such materials. [Emphasis added.]

Despite the presumption that, all other things being equal, a contractor who uses Government-furnished materials is entitled to less profit than one who does not, the preponderance of evidence before the court does not warrant reducing plaintiff's profit because it used Government surplus equipment.

The Renegotiation Performance Report by NASA to assess plaintiff's performance during 1966 indicates that

plaintiff "was Economical in Use of Materials, Facilities, and Manpower, and was otherwise effective in Controlling Production Costs." Assuming this assessment by the contracting agency to be correct, plaintiff's use of Government surplus engines, propellers, and spare parts is one source of plaintiff's cost effectiveness. The record suggests that cost savings were, in fact, passed on to the Government as a result of plaintiff's having used Government-furnished parts. Defendant introduced no evidence to support a contrary inference.

Plaintiff introduced additional evidence indicating that its use of military surplus equipment, while saving the initial cost of new engines and propellers, made spare parts difficult to locate and maintenance costs difficult to predict. Regulation 1460.14(b)(2) in effect provides that a contractor which uses materials it owns itself is entitled to compensation for its investment and for its assumption of the risks of ownership. Although it was not the owner of the parts provided by the Government, plaintiff was obligated by contract to maintain the leased property in good condition and remained "solely and fully liable for any damage to, or loss or destruction of, the leased property resulting from any cause whatsoever." Plaintiff was actually in a less favorable position than if it had purchased the parts itself because it bore the risk of loss without benefit of other incidents of ownership. For example, had plaintiff owned the parts, it would have been entitled to earn profit on the value of its investment in the parts, to charge depreciation against current income, and to retain the parts after termination of the NASA contract.

During 1966, plaintiff purchased a significant amount of the fuel and oil it required at Government facilities at prices lower than those prevailing at commercial airfields. There is no evidence in the record to suggest that plaintiff's profit should be reduced because of this contractual privilege. In fact, the fuel cost estimate which Aero Spacelines provided to NASA contract negotiators assumed that 80 percent of plaintiff's fuel purchases would be made at Government installations. This representation was presumably taken into

account in negotiations between plaintiff and the Government.

Plaintiff employed no subcontractors. 32 C.F.R. § 1460.14 (b)(3)(i) (1974) states the general rule that "* * * a contractor who subcontracts work may not reasonably expect to be allowed as large a profit thereon as if it had done the work itself, * * *." Plaintiff benefits in establishing its prima facie case from the fact that it employed its own facilities and skill in performing under contract NAS 8–15476.

The final statutory subfactor under "character of business" is rate of turnover. Rates of turnover viewed as significant in defense contract analysis and in renegotiation are (1) the turnover of a contractor's equity capital investment,[19] (2) the turnover of total capital investment of the contractor,[20] and (3) "inventory turnover," the ratio of sales to average inventory on hand.[21] Each of these ratios may be relevant in a particular context, depending upon the nature of the business being evaluated and upon comparisons with businesses having similar characteristics.

Because plaintiff provided a service rather than manufactured a product, rate of turnover in the sense of "inventory turnover" is irrelevant in evaluating plaintiff's performance.

Renegotiation Board Regulation 1460.14(b)(4) suggests that turnover ratios may be useful in evaluating whether plaintiff made efficient use of the resources at its disposal, provided that relevant comparisons are made with the turn-

[19] *See, e.g.*, GAO, REPORT TO CONGRESS: DEFENSE INDUSTRY PROFIT STUDY 13 (GAO Report B–159896, 1971) (reprinted as Appendix IV to *Hearings on Defense Industry Profit Study of the General Accounting Office Before the Legislation and Military Operations Subcomm. of the House Comm. on Government Operations*, 92d Cong., 1st Sess. (1971)). The GAO report defines turnover of equity capital investment as sales divided by the total dollar value of "capital shares, retained earnings, retained-earning reserves, minority interests, and such other equity-type items as deferred-investment tax credits." *Id.*

[20] *See, e.g., id.* The GAO report defines turnover of total capital investment as sales divided by total capital investment, which is defined as "total investment in all assets used in the business, exclusive of any Government-owned or leased items. In other words, the total capital provided by creditors (debt capital) and the owners of the business (equity capital)." *id.* at 13, 12.

[21] Turnover in the third sense was used by the Tax Court in *LTV Aerospace Corp.* v. *Renegotiation Board*, 51 T.C. 369, 399 (1968).

over ratios of businesses with similar characteristics.[22] Plaintiff's net worth turnover ratio in 1966 was 4.2 (sales, $3,926,239, divided by beginning net worth, $926,839); its capital turnover ratio was 1.6 (sales, $3,926,239, divided by beginning capital, $2,460,150). Since neither of the parties has introduced relevant comparative data, it is impossible for the court to assess the significance of plaintiff's turnover ratios. Accordingly, this subfactor has no weight in evaluating the reasonableness of plaintiff's profit.

Contribution to the Defense Effort

Section 103(e)(4) of the Renegotiation Act, 50 U.S.C. App. § 1213(e)(4) (1970), provides that there shall be taken into consideration the—

> [n]ature and extent of contribution to the defense effort, including inventive and developmental contribution and cooperation with the Government and other contractors in supplying technical assistance; * * *.

Though plaintiff was a contractor for the civilian space agency, plaintiff is nevertheless entitled to be evaluated under this statutory factor. The Renegotiation Board found that plaintiff's contract did have a direct and immediate connection with the national defense and was, accordingly, not entitled to exemption from renegotiation. The Board's decision on this particular issue is not subject to redetermination in this court.[23] Hereafter, the term "contribution to the

[22] 32 C.F.R. § 1460.14(b)(4) (1974). In a report on Recommendation 22, entitled "Practices and Procedures Under the Renegotiation Act of 1951," prepared for the Administrative Conference of the United States by Professor Dennis S. Aronowitz, it is noted that the Renegotiation Board in fact uses specific comparisons with competitors, derived from confidential data or the experience of Board personnel, to evaluate quantitative factors such as profit to net worth, profit to sales, amounts of Government capital employed, and rate of turnover. Aronowitz, Report of the Comm. on Claims Adjudications in Support of Recommendation No. 22 [Practices and Procedures under the Renegotiation Act of 1951], 1 RECOMMENDATIONS AND REPORTS OF THE ADMINISTRATIVE CONFERENCE OF THE UNITED STATES, 665, 679–80 (1970).

[23] Section 106(a)(6) of the Renegotiation Act of 1951, 50 U.S.C. App. § 1216(a)(6) (1970), *as amended*, (Supp. III, 1973), providing for mandatory exemption of "any contract which the Board determines does not have a direct and immediate connection with the national defense," also states that the Board's decision on this issue is not reviewable in this court. Plaintiff requested exemption under this provision of the statute. Exemption was formally denied by the Board.

space effort" is used synonymously with "contribution to the defense effort."

32 C.R.F. § 1460.13(b) (1974), which fleshes out "contribution to the defense effort," provides:

> * * * Credit will be given under this factor, in such degree as as [sic] the facts may warrant, for * * *(4) experimental and developmental work of high value to the defense effort; * * * (6) performance under difficult environmental or geographical conditions or hazardous working conditions; * * * or (8) performance, assistance, or service considered otherwise exceptional.

The cited subfactors in this regulation apply to plaintiff.

In mid-1965, NASA was interested in the Super Guppy primarily as a mode of transportation for Douglas S–IVB stages, which were used as the third stage of the NASA Saturn-V launch vehicle. The S–IVB stage was so large and heavy that even the Pregnant Guppy, which NASA had been using since 1963, was not capacious or powerful enough to accommodate it. A larger aircraft was needed to carry the stage, which measured 21.7 feet in diameter and 58.3 feet in length and weighed 25,000 pounds unfueled. The Super Guppy, which had a cargo compartment with an inside diameter greater than that of the S–IVB stage for 60 feet of its length, was just large enough to hold the S–IVB and had been developed with the dimensions of the S–IVB in mind.

Before the advent of the Super Guppy, the only way NASA had to transport the S–IVB stages was by ocean-going barges from California through the Panama Canal. Ocean shipment via the canal took 4 weeks. Delivery of the stages by air required only 1 day, accelerating delivery by practically the full 4 weeks formerly needed.

Manufacturer's contract delivery dates for the S–IVB stages had been set 4 weeks in advance of the dates they were needed at Kennedy Space Center to provide enough time for delivery by ocean transportation. Nevertheless, the ocean-going barge method was unacceptable to NASA because of the time required to complete each shipment. NASA desired *early* delivery of the stages to gain additional time for testing and provide a hedge against unforeseen development problems.

In fact, NASA considered accelerated delivery so important that in June 1966 it incorporated approximately $26.2 million in schedule incentives into the Saturn I–C stage and Saturn IV–B stage contracts. NASA claimed the value to the space program of accelerated delivery was substantially in excess of this amount. According to NASA's Renegotiation Performance Report on the contractor's 1966 operations (1966 Renegotiation Performance Report), the Super Guppy "resulted in considerable savings in cost and time over other acceptable means of transportation."

The importance of Aero Spacelines' service to the space program is underscored by the agency's rejection in 1968 of plaintiff's proposal to revise the contract to permit Aero Spacelines to carry supplies for other Government agencies. In denying plaintiff's request, NASA stated its position as follows:

> The existing launch schedule for the next 12–18 months, requiring rapid reaction to changing requirements, demands immediate availability of the Guppies. If the Guppies are not under the proximate control of NASA, * * * our response time may be seriously jeopardized. This could delay priority cargoes 2–3 days with a resultant impact on launchings and added costs.

As the foregoing facts show, plaintiff is entitled to very favorable consideration for its ingenuity in recognizing the need for and in implementing the means to provide a unique air transportation service which met NASA's need for speed and flexibility in carrying components used in the space program. Plaintiff's 1966 Renegotiation Performance Report noted:

> Aero Spacelines is the only contractor, to date, that has taken the initiative and invested private capital to design, develop and fabricate aircraft capable of transporting outsize cargo such as Saturn Stages.

Plaintiff provided an exceptional service within the meaning of the fourth and eighth subfactors listed in 32 C.F.R. § 1460.13(b).

The frequently difficult conditions under which plaintiff operated (subfactor 6 of the regulation) are discussed, *infra*, in connection with plaintiff's risk and plaintiff's efficiency.

Opinion of Trial Judge

Extent of Risk Assumed

In determining whether profits are excessive, § 103(e)(3) of the Act, 50 U.S.C. App. § 1213(e)(3) (1970), requires that consideration be given to the "[e]xtent of risk assumed, including the risk incident to reasonable pricing policies." 32 C.F.R. § 1460.12(b)(1) (1974) notes that risks to be considered *include, but are not limited to,* risks incident to close pricing policies. Nonpricing risks enumerated in the regulation are listed by way of example and do not purport to be all-inclusive. However, risks that may be considered in connection with renegotiation may not be "mere speculative or unlikely possibilities." 32 C.F.R. 1460.12 (b)(1) (1974).

Plaintiff's nonpricing risks can be separated into "business risks" and "operating risks." These categories have no special analytical significance and are adopted only for convenience in explaining the nature and extent of plaintiff's risks.

Business Risks

Plaintiff's contract with NASA envisioned a total duration of 4 years, yet had to be renewed year by year, at the option of NASA. Contrary to plaintiff's contention, this was not a significant source of business risk, since there was little danger of premature contract termination on the part of the space agency. The parties have stipulated that in December 1965 plaintiff knew of NASA's commitment to place a man on the moon by 1970. Because of this commitment, plaintiff also knew there was a high probability that NASA would continue the contract throughout all of its option periods. NASA ultimately did exercise the options and renew the contract for each of the succeeding 3 years. NASA maintained a program of schedule incentives for the stage manufacturer in order to ensure delivery far enough in advance of the date the stages would be needed to allow reversion to barge transportation. However, this measure was merely a precaution against the possibility that the more desirable air transportation might become unavailable.[24]

[24] NASA's precaution is relevant to the space agency's contemporaneous assessment of plaintiff's operating risks, discussed *infra*.

A far more significant business risk incidental to plaintiff's performance of contract NAS 8-15476 was the risk that its aircraft, particularly the Super Guppy, would soon become obsolete. Plaintiff's 1966 Renegotiation Performance Report observed:

> Contractor assumes some risk of investment since aircraft was developed by own capital and customer demand for use of aircraft has to date been limited. The nature of the aircraft is such that it is subject to higher obsolescence than is normally recognized with conventional cargo aircraft. * * *

Since the Super Guppy had been developed on a limited budget of private capital and on a tight time schedule, many tests which would have been required for commercial certification of a new aircraft by the Federal Aviation Administration were not done. This circumstance did not impair the usefulness of the Super Guppy to NASA because, as a "public aircraft" under the auspices of a particular governmental agency, the plane was exempt from many regulations normally enforced by the FAA and the Civil Aeronautics Board. However, without complying with FAA and CAB regulations, the Super Guppy could not be used for *commercial* cargo transportation after termination of the NASA contract. Testimony at trial indicated that such compliance would require extensive additional modifications and testing. Accordingly, the risk that the Super Guppy would soon become obsolete was real and is an important element of plaintiff's prima facie case.

Like the Super Guppy, the Pregnant Guppy was not commercially certificated. Whether it would be difficult to convert the Pregnant Guppy to commercial use does not appear from the record.

Defendant's expert witness, a specialist in Government procurement, testified that transporting oversize cargoes for NASA enhanced plaintiff's position to enlarge either its service market or its aircraft development and production market through attendant "space age publicity." Plaintiff's association with NASA, the witness stated, enhanced plaintiff's standing in commercial as well as Government markets. This testimony was highly impressionistic and exceptionally

difficult to verify. In the absence of any concrete evidence that plaintiff was actually able to capitalize on its position as a NASA supplier, it is found that the assertedly beneficial association did not appreciably offset plaintiff's risk.

Operating Risks

Plaintiff's operating risks during 1966 arose primarily from the circumstances under which the Super Guppy had been developed and from the fact that 1966 was the first year the Super Guppy provided air transportation services under the NASA contract.

Development of the Super Guppy through the stage of wind tunnel testing occurred before plaintiff Aero Spacelines, Inc., acquired Havenhurst. Mr. Kirk Irwin, vice-president of plaintiff and an aeronautical engineer, testified that the amount of wind tunnel testing which had been done on the Super Guppy wind tunnel model was an "insignificant amount" by any standard to which the witness was accustomed. According to Mr. Irwin, limited capital and lack of Government funding, as well as NASA's "very tight needs schedule," permitted only a minimal amount of predictive analysis of performance, stability, and controllability to be done.

Like the wind tunnel testing of the Super Guppy model, the flight test program for the aircraft itself was not extensive. The 96 hours of flight testing done on the Super Guppy were only between one-fourth and one-sixth of the number of hours of tests which would normally be done in the aerospace industry to evalute comparable airframe modifications.

The flight test program for the Super Guppy took place from August 31, 1965, about 2 weeks after acquisition of Havenhurst by plaintiff, until March 3, 1966. Almost immediately upon completion of the abbreviated flight test program, on March 25, 1966, NASA changed the primary mode of transportation for Saturn-IVB stages from water to air. On April 6, 1966, NASA began airlifting *all* S–IVB stages to Kennedy Space Center. Because the Super Guppy had been developed on a tight time schedule, the aircraft

began actual operations with a number of important questions about its flight performance still unresolved. Many tests which would have been required for commercial certification of a new aircraft by the Federal Aviation Agency were not done on the Super Guppy, which was exempted from FAA certification requirements by its status as a "public aircraft" under NASA auspices.

By the time wind tunnel testing of the Super Guppy was completed in May 1965, the aircraft itself was already well along in construction. During the period of construction, a number of structural deficiencies, relative to FAA requirements for commercially certified aircraft, were uncovered in the design of the Super Guppy. Since construction had been under way for some time, rather than requiring correction of the deficiencies, NASA imposed special operating limitations on the Super Guppy. These limitations were more stringent than those normally observed by commercially certified aircraft. As a result, the Super Guppy entered service in March 1966 subject to special operating rules to be observed by Aero Spacelines' flight crews. The Super Guppy was still undergoing evaluation as it entered service, and final flight manual operating limitations were approved by the NASA Super Guppy Ad Hoc Technical Committee on June 21, 1966, more than 3 months after the Super Guppy had begun full contract operations.

Though NASA was willing to accept operating limitations in the interest of getting the Super Guppy into service, uncertainties about the aircraft and special operating limitations were a continuing source of risk to Aero Spacelines, Inc., in performing under its contract with the space agency.

The operating limitations which Aero Spacelines' crews were required to observe created a special insurance risk. The hull, liability, excess liability, and loss of use insurance policies covering the Super Guppy all included or incorporated by reference the following exclusion from coverage:

> THIS POLICY DOES NOT APPLY:—
>
> * * * * *
>
> (3) *While the aircraft* is used for any unlawful purpose or *is operated otherwise than in compliance with* the

terms of its Airworthiness Certificate and *the approved operating limitations contained in its Airplane Flight Manual* or other documents associated with the Airworthiness Certificate * * *. [Emphasis added.]

Plaintiff's expert technical witness testified that where, as in the case of the Super Guppy, operating limitations in the flight manual are more exacting than normal FAA regulations, a pilot must exercise a greater degree of care. There is a correspondingly higher risk that the pilot may violate the flight limitations, rendering the policies inapplicable in case of loss. Although the precise extent of plaintiff's additional risk cannot be quantified, the evidence indicated that flying the Super Guppy was substantially more risky than flying ordinary cargo aircraft.

Since there were no comparable special limitations on the operation of the pregnant Guppy, which had been flying without mishap since 1963, plaintiff made no special showing of operating risk with respect to the Pregnant Guppy.

Plaintiff's operating risk in 1966 was increased by the need to train new crews to fly both the Super Guppy and the Pregnant Guppy. Before August 1965, when the Super Guppy was flown for the first time, Aero Spacelines had employed 10 crew members, six pilots, and four flight engineers. The advent of the Super Guppy literally doubled Aero Spacelines' fleet, from one to two aircraft, and necessitated training of six more pilots and four more flight engineers. All of Aero Spacelines' 20 flight personnel had to be trained to fly the Super Guppy, and 10 had to learn to operate the Pregnant Guppy. The training period commenced in August 1965 and continued through November 1966.

A ground flight simulator was not available for the Super Guppy, so flight training had to take place in the aircraft. Flight training represents the most critical period of operation of any aircraft. Flight training of crews may actually be more dangerous than flight testing of an aircraft, which is planned in detail and executed under controlled conditions.

Risks inherent in flying the Super Guppy were not merely statistical or speculative, but were evident in the

actual experience of the contractor.[25] On September 25, 1965, during flight testing, the blunt nose of the Super Guppy caved in because of insufficient structural strength. The aircraft was able to land safely because inspection hatches and cargo doors in the tail section blew out, preventing the plane, which was scooping in air as it moved forward, from exploding.

In its own planning, NASA recognized the riskiness of plaintiff's 1966 operations. In response to a General Accounting Office report criticizing NASA for relying upon schedule incentives to stage manufacturers to accelerate delivery NASA replied as follows:

> *The Super Guppy was a one-of-a-kind aircraft.* It originally was to have been certified by the end of CY 1965. However, due to two major problems in late CY 1965 and early CY 1966 it was not finally certified until 30 March 1966 due to: (1) the aircraft nose caved in during a test flight due to inadequate structural strength, (2) a propeller stress problem. Since prior operational experience with the aircraft was not available and with the problems that the aircraft had just experienced, it would have been very shortsighted and derelict on the part of NASA to, at the same time, make a major adjustment in the S–IVB schedule to compensate for the potential time gained. *There was no assurance at that time (and the only way this assurance could be realized was through operational use and experience) that NASA could totally depend on this one-of-a-kind, outsized aircraft for S–IVB transportation. Until confidence could be built up in this aircraft through usage, NASA elected not to adjust the delivery schedule and thereby retain the capability to revert to S–IVB water transportation without impacting the S–IVB delivery schedule to KSC.* [Emphasis added.]
>
> GAO, REPORT TO CONGRESS: INCENTIVE PROVISIONS OF SATURN V STAGE CONTRACTS 79 (GAO Report B–161366, 1970) (page 40 of Appendix II).

If the Super Guppy had been destroyed, NASA could have reverted to water transportation. Plaintiff, on the other hand,

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[25] 32 C.F.R. § 1460.12(b)(1) states: "In general, the Board will consider whether the contractor's performance of renegotiable business is free from risk, or subject to it, *on the basis of actual experience and not mere speculative or unlikely possibilities.*" (Emphasis added.)

would have lost the revenues generated by the Super Guppy. The Super Guppy accounted for more than half of the guaranteed monthly payment received by plaintiff. If the Super Guppy had not been able successfully to complete its test program, contract NAS 8–15476 provided that the mileage guarantee, analogous to a rental fee for NASA's use of the two Aero Spacelines' aircraft, would be reduced from $243,900 per month, the contract guarantee for both planes, to $120,000 per month, the former mileage guarantee for the Pregnant Guppy alone. Had the services of the Super Guppy been lost during contract operations, a circumstance not specifically covered by the contract, it is virtually certain that a price adjustment would have been required by NASA, exercising its rights under the standard default clause. The Super Guppy was an integral part of plaintiff's operations in 1966, flying 224,588 miles or almost half of the total 474,965 miles flown in 1966 by both of Aero Spacelines' aircraft.

NASA's 1966 Renegotiation Performance Report on plaintiff stated that "Technical and Engineering personnel assistance furnished [by NASA] is not of the nature which would lessen the contractor's risk."

One example of risk cited in 32 C.F.R. § 1460.12(b)(1) (1974), other than pricing risk, which contractors may assume is the risk of guaranteeing—

> * * * quality and performance of the product notwithstanding uncertainties as to the quality obtainable from their plants, particularly with respect to products which may be more or less abnormal to them.

At the beginning of 1966, the ability of plaintiff's Super Guppy and new crews to perform without mishap was uncertain. As the quoted regulation suggests, the risk stemming from the uncertainty is an element of plaintiff's prima facie case.

Pricing Risk

Plaintiff operated under a firm fixed-price contract under which it assumed full responsibility for its costs and bore the entire risk that costs might outrun the established contract price. *Cf. Boeing Co.* v. *Renegotiation Board*, 37 T.C. 613, 643 (1962), *appeal dismissed*, 325 F. 2d 885 (9th Cir. 1963),

cert. denied, 377 U.S. 923 (1964). This factor aids plaintiff in establishing its prima facie case.

Efficiency of Contractor

Section 103(e) of the Act, 50 U.S.C. App. § 1213(e) (1970), provides that in renegotiation, *favorable consideration must be given* to—

> * * * the efficiency of the contractor * * * with particular regard to attainment of quantity and quality production, reduction of costs, and economy in the use of materials, facilities, and manpower; * * *.

Plaintiff has established its entitlement to favorable recognition for efficiency.

A Renegotiation Board regulation, 32 C.F.R. § 1460.9(b) (1974), explains that a contractor's efficiency is judged by the quantity of its production (for example, in relation to available facilities; meeting of production schedules; expansion of facilities); quality of production; reduction of costs (for example, a decrease in costs per unit of sales between fiscal years and as compared with contractors producing similar products and having comparable operations); and economy in use of materials, facilities and manpower.

The Renegotiation Performance Report on plaintiff's 1966 operations indicated that plaintiff met contract requirements, including delivery schedules. Plaintiff's meeting its delivery schedules evidenced better than ordinary efficiency. Plaintiff produced credible evidence that special operating limitations, including the need to avoid icing and turbulent conditions, made the Super Guppy an exceptionally difficult airplane to schedule. Despite difficulties in scheduling the Super Guppy, plaintiff met its contract deadlines. The quality of plaintiff's production is, in this case, synonymous with plaintiff's meeting its production schedules.

Plaintiff expanded its facilities in 1966 by doubling its fleet of oversize cargo aircraft from one to two. Plaintiff is, accordingly, due favorable recognition of this fact.

Plaintiff produced no evidence relating its average per mile costs in 1966 to those in earlier years; accordingly, plaintiff has not demonstrated any significant data relating to cost

reduction which would assist it in establishing its prima facie case.

Plaintiff's 1966 Renegotiation Performance Report affirms in general terms that plaintiff "* * * was Economical in Use of Materials, Facilities, and Manpower, and was otherwise effective in Controlling Production Costs." Absent effective rebuttal evidence on this point by defendant, plaintiff is accorded favorable recognition for its economy.

Net Worth and Capital Employed

Section 103(e)(2) of the Act, 50 U.S.C. App. § 1213(e)(2) (1970), provides that "[t]he net worth, with particular regard to the amount and source of public and private capital employed," shall be taken into account in determining whether profits have been excessive. 32 C.F.R. § 1460.11(b) (1974), the Renegotiation Board regulation dealing with this statutory factor, states that although the amount of net worth employed will generally be that existing at the beginning of the year, significant changes in net worth occurring during the course of the year must be taken into account. This is such a situation. Plaintiff's ending net worth (shareholder's equity) of $2,206,781 was more than twice its beginning net worth of $926,839. Accordingly, an average of the two figures may be more indicative of the amount of plaintiff's equity than either beginning or ending net worth taken alone. Plaintiff's return on its average net worth of $1,566,810 was 72.31 percent.

Defendant asserts that plaintiff's "112 percent" return on its net worth in 1966 was 24 percent higher than the "88 percent" return on net worth allowed plaintiff in its settlement with the Renegotiation Board for the partial fiscal year ending August 12, 1965. This fact is not helpful in determining whether plaintiff realized excessive profits in 1966 for several reasons:

1. The 112 percent figure is numerically inaccurate if defendant is referring to return on beginning net worth, which was 122 percent for 1966;

2. No evidence appears in the record to illuminate how defendant's expert arrived at the 88 percent profit figure for 1965 or, more specifically, whether he based

the figure on beginning net worth, final net worth, or some average of the two if the beginning and final amounts differed significantly. Without knowing how defendant derived the 88 percent profit on net worth figure, the court cannot conclude that that figure provides a meaningful basis for assessing the reasonableness of plaintiff's 1966 return on net worth; and

3. Defendant's choice of beginning net worth as the 1966 basis for comparison disregards 32 C.F.R. § 1460.-11(b), *supra*, which requires significant changes in net worth during the course of a given year to be taken into account. In fact, plaintiff's return on average net worth in 1966 was 72 percent, 16 percent *lower* than the undocumented 88 percent figure defendant contends plaintiff's predecessor realized during the first part of 1965.

If the Government had so chosen, it might have related plaintiff's 1966 net worth return to that of companies similar to plaintiff. In *LTV Aerospace Corp.* v. *Renegotiation Board*, 51 T.C. 369, 405 (1968), the Tax Court implied that for net worth return data to be meaningful, the court must be told, at the minimum, "what an average rate of return would be for a company like" the plaintiff.

Plaintiff, it is true, provided a unique air transportation service for oversize cargoes using only two aircraft, both of which it had fabricated itself. It does not follow, however, that no relevant comparisons can be made between plaintiff and, for example, companies which provide more conventional air transportation services. If there are limitations to such a comparison or if air frame manufacturers' rates of return are a more appropriate basis for comparison, the parties should at least address these issues. Without meaningful comparative data, with respect either to plaintiff's own prior experience or to the experience of an industrial group demonstrated to have some relevance as a basis for comparison, the court has no yardstick with which to assess the net worth statutory factor and is asked, in effect, to determine excessive profits in a factual vacuum.[26]

[26] The court takes judicial notice that industrial statistics relevant to renegotiation are available in reliable and readily available sources. For example, the Internal Revenue Service publishes annually statistics of income compiled from corporation income tax returns and broken down by major and minor industries. This annual compilation includes aggregate data on business

The net worth statutory factor requires that "particular regard [be given] to the amount and source of public and private capital employed." Capital employed is defined in 32 C.F.R. § 1460.11(b)(3) (1974) as "the total of net worth, debt, and any assets furnished by the government or customers not contained in the contractor's records." The source of capital employed is relevant for renegotiation because "* * * where a contractor risks relatively little of its own capital it is primarily a manager of property, and thus not entitled to as great a return for risk-taking as a contractor which supplies its own assets." *LTV Aerospace Corp.* v. *Renegotiation Board*, *supra* at 405. Furthermore, "* * * a contractor which uses its own assets is entitled to an element of return equivalent to the rental value

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receipts, cost of sales and operations, net income, taxable income, total assets, net worth, depreciable assets, and annual depreciation. In this instance, data are provided both for transportation equipment: aircraft, guided missiles and parts, and for air transportation. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME 1966: CORPORATION INCOME TAX RETURNS. For manufacturing corporations, the FTC and SEC jointly publish a quarterly financial report for manufacturing corporations, containing much the same data. In addition, of relevance to this particular case, the Aerospace Industries Association of America, Inc., also publishes annually a compilation of aerospace facts and figures. *See* AEROSPACE INDUSTRIES ASSOC. OF AM. INC., AEROSPACE FACTS AND FIGURES: 1967 (containing 1966 data).

Moreover, the parties may have recourse to general, aggregate industry performance data actually relied upon by the Renegotiation Board. Professor Aronowitz suggests in his report to the Administrative Conference of the United States on the practices and procedures of the Renegotiation Board that much composite data used by the Board "* * * was derived from public sources, * * *; other composite data appeared to be derived from the Board's own experience with a particular industry but was sufficiently generalized so as to be publishable without risking violation of the confidentiality restrictions" imposed upon the Board by 18 U.S.C. § 1905 (1964) and the Internal Revenue Code of 1954, § 7213. Aronowitz, *supra* note 22, at 680.

Introduced as evidence by the parties, such information would fit within the hearsay exception, set forth in the recently enacted Federal Rules of Evidence, Rule 803 (17), for—

"Market reports, commercial publications. Market quotations, tabulations, lists, directories, or other published compilations, generally used and relied upon by the public or by persons in particular occupations."

Although these sources also appear to meet the requirement of Federal Rule of Evidence 201 for judicially noticeable facts, which must be "capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned," the court declines to take judicial notice of specific items of comparative information because of the difficulty of identifying and making the relevant comparisons without assistance from the parties. *See* the analogous refusal by the Tax Court to take judicial notice of "learning curve" evidence and findings in another case, citing "the difficulty we would face in interpreting such data if it were before us," in *LTV Aerospace Corp.* v. *Renegotiation Board*, *supra* at 402.

of the assets; a contractor using the assets of others is not." *Id.*

It should be noted at the outset that plaintiff utilized primarily its own capital. Capital provided by plaintiff itself in 1966 averaged $2,801,916. Defendant argues that plaintiff's profit should be reduced because the Government provided plaintiff with surplus aircraft parts, engines, and propellers at no cost during 1966. Although the "stated value" or undepreciated original cost to the Government of this equipment was $1,424,476, defendant failed to introduce any evidence to show what value the aircraft parts had in 1966. It is impossible, therefore, for the court to estimate accurately what proportion of the total capital employed by plaintiff was supplied by the Government.[27]

Furthermore, as the Tax Court observed in *LTV Aerospace Corp.*, *supra* at 405, it does not necessarily follow that a contractor which uses capital supplied by others is entitled to a smaller *rate of return on its own net worth.*

Unlike the situation contemplated by 32 C.F.R. § 1460.11 (b)(4) (1974), in which a "contractor's contribution tends to become one of management only," plaintiff had a substantial quantity of its own capital at risk in performing under contract NAS 8-15476. It is true as an abstract proposition that a contractor performing a particular service with a given quantity of capital supplied only in part by itself is entitled to less profit than a contractor which performs the same service with the same amount of capital completely provided by itself. However, defendant has failed to relate this basic principle of renegotiation to the facts of this case.

Defendant, after pointing out that plaintiff was paid promptly for its services, argues that capital for plaintiff's operations was provided to a considerable degree by defendant. Implicit in defendant's argument is the idea that plaintiff was thus relieved of the cost of borrowing working capital. As was the case in *LTV Aerospace Corp.* v. *Renego-*

[27] The Tax Court similarly declined to speculate about the amount or percentage of total capital supplied by noncontractor sources in *LTV Aerospace Corp.* v. *Renegotiation Board*, *supra* at 405.

tiation Board, *supra* at 406, where the Government made a similar argument, no payments were made until after the services had been rendered. Plaintiff bore all expenses under its contract and paid labor, fuel, and other costs as they were incurred; plaintiff did not invoice the Government for miles flown until *after* the miles were flown. Therefore, as the Tax Court ruled in the *LTV Aerospace* case, plaintiff "is not entitled to prices which include amounts to cover the costs of borrowing working capital, but that fact does not justify reducing [plaintiff's] allowable profit." *Id.* Defendant has provided no evidence suggesting that the negotiated contract price included provision for costs of borrowing working capital later made unnecessary by the Government's prompt reimbursement of plaintiff.

Repair and maintenance expenditures were similarly paid promptly. Although prompt reimbursement of these expenses probably reduced plaintiff's need to borrow money for repairs, defendant provided no evidence of what specific impact, if any, prompt payment had on plaintiff's profitability. Furthermore, defendant provided no evidence suggesting that prompt payment for miles flown and for repair and maintenance costs was not taken into account in establishing the amount plaintiff would be paid under contract NAS 8-15476. On the contrary, defendant's witness testified at trial that "* * * payment procedures may be negotiated between the government and the contractor in each case * * *" as one of the variables in setting the contract price.

The Government's expert witness observed that a majority of fixed-price production contractors receive payment only after they have completed delivery of the goods contracted for, implying that plaintiff somehow received more favorable treatment than is normally given Government contractors. Assuming the witness' comparison of a contract for delivery of goods with a contract for provision of a service to be a valid one, plaintiff does not suffer from such a comparison because it was not paid for transportation of Government freight until after the service was completed.

Like the rate of return on net worth, rate of return on capital employed is meaningful only in the context of rele-

vant comparisons with the net worth and capital returns of other firms. The record in this case is devoid of such comparisons.

As the preceding discussion indicates, the evidence fails to show that plaintiff's 1966 profits were excessive when measured by the net worth and capital statutory factor.

Reasonableness of Costs and Profits

Section 103(e)(1) of the Act, 50 U.S.C. App. § 1213 (e)(1) (1970), directs that in determining whether excessive profits have been realized, there shall be taken into account the "[r]easonableness of costs and profits, with particular regard to volume of production, normal earnings, and comparison of war and peacetime products." The focus of this statutory factor is twofold because it is concerned both with the reasonableness of a contractor's costs and with the separate issue, the ultimate one in renegotiation, reasonableness of the contractor's profits.[28]

As the renegotiation statute itself suggests and as 32 C.F.R. § 1460.10(b) (1974) makes explicit, reasonableness of a contractor's costs and reasonableness of its profits must be determined on the basis of relevant comparisons. The regulation makes many references to comparative data, including the following:

> (b)(1) * * * Comparisons will be made with the contractor's own costs and profits in previous years and with current costs and profits of other contractors, if such information is available. * * * Low costs with relation to other contractors, when clearly established and shown to be the result of efficiency in management, are especially significant and must receive favorable consideration. * * *

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[28] In two of its renegotiation decisions, the Tax Court expressly declined to treat reasonableness of profits as other than the ultimate issue in the case:

"The question of the reasonableness of Temco's profits is too closely tied with the question of the existence and amount of excessive profits to be considered separately from that question." *LTV Aerospace Corp.* v. *Renegotiation Board, supra* at 408.

"As to the 'reasonableness' of petitioner's profits it is enough to say this will be the ruling consideration in this proceeding." *North Am. Aviation, Inc.* v. *Renegotiation Board,* 39 T.C. 207, 228 (1962).

(2) Consideration for comparative purposes will be given to profits of the contractor, and of the industry, on products and services not subject to renegotiation, especially in cases in which the renegotiable business involves products or services substantially similar to those not subject to renegotiation. * * *

As noted, *supra*, renegotiation is a system of variable profit rewards intended to recover excessive profits without impairing incentives for Government contractors to distinguish themselves by innovativeness and efficiency. A contractor's entitlement to profit is to be a function of the excellence of his contribution. A reasonable profit can be established only on a comparative basis because it is impossible to say what a particular product or service is intrinsically worth.

The regulation cited above broadly recognizes two types of comparisons: (1) comparison with the contractor's own prior performance and profitability, and (2) comparisons with profits of the contractors and of the industry on similar products or services. Comparisons, of course, have varying degrees of probative weight depending upon how close they are demonstrated to be.

As discussed, *supra*, in connection with plaintiff's risk, plaintiff operated under a firm fixed-price contract which obligated it to bear any increases in the cost of performance without passing them on to the Government. The amount of risk assumed by a contractor under a firm fixed-price contract depends upon how realistic his cost estimates are and upon the "closeness" of his pricing, the margin between the anticipated costs and the price set to cover costs and yield a profit.

Defendant has not directly questioned the reasonableness of the 1966 cost figures actually shown on plaintiff's accounting statement for renegotiation. Instead, defendant argues, in effect, that the price originally set in contract negotiations "must have" generated an unreasonably high profit for plaintiff because "the reasonableness of plaintiff's costs has been questioned from the outset." Defendant urges that NASA was handicapped in negotiating with plaintiff because a

NASA auditor was denied access to records that would reveal plaintiff's investment in the Super Guppy, a figure needed to enable NASA to prepare an estimate of plaintiff's annual depreciation costs.

This argument does not shed much light on the central issue of this case, which is whether *profits actually realized in 1966* were reasonable or excessive. It is instead an implicit appeal to the court to second guess NASA's negotiators by repricing the contract. This the court will not do. Although renegotiation was originally conceived "* * * as a procurement function, a repricing procedure in connection with specific contracts, * * *" this view of renegotiation "* * * became subordinated to the idea of an over-all retroactive recovery of excessive profits." [29] Renegotiation has come to be "increasingly divorced from procurement in both philosophy and administration." [30] This court clearly outlined the distinction between procurement and renegotiation in *Newport News Shipbuilding & Dry Dock Co.* v. *United States*, 179 Ct. Cl. 97, 108, 374 F. 2d 516, 526 (1967):

> * * * the Renegotiation Act provides for the recovery of excessive profits not on a contract-by-contract basis, but upon the basis of all receipts and accruals from all covered contracts during the relevant fiscal year. 50 U.S.C. App. § 1213(f). Under renegotiation, the contractor's costs are determined, on an overall fiscal year basis, based upon deductions allowable under the Internal Revenue Code—not upon cost standards established by the Armed Services Procurement Regulations. * * * It was incumbent upon government procurement officials to administer contracts to insure that the prices obtained were fair and reasonable. 32 C.F.R. (Rev. 1954, Cum. Supp. Jan. 1960), § 3.808–1. But if negotiations pursuant to contractual price redetermination, or escalation provisions, etc., still result in contractors obtaining excess profits on the basis of over-all receipts and accruals during a fiscal year, then the Renegotiation Act provides a procedure to recapture the excess—establishing what amounts to a last chance for the elimination of excessive profits. Renegotiation is thus "focused on recapture of

[29] R. C. Osborn, *supra* note 13, at 99.
[30] J. MILLER, THE PRICING OF MILITARY PROCUREMENTS 174 (1949).

excessive profits rather than on prevention by repricing;" it is "a supplement to effective pricing"—not a substitute. Braucher, *Renegotiation Act of 1951*, 66 Harv. L. Rev. 270, 276, 312–13 (1952). [Footnote omitted.]

Even if renegotiation were a repricing procedure, defendant has failed to show that NASA was prejudiced in its dealings with plaintiff because of withheld information. On the contrary, the record shows NASA's cost analysts to have been vigilant and aggressive in dealing with plaintiff. The contractor's proposed costs were pared substantially in developing the basis for NASA's rate proposal. NASA compensated for plaintiff's early failure to provide cost information for the Super Guppy, which had not yet been completed, by estimating a conservatively low value for the aircraft. In fact, the estimated value was only 60 percent of the $1,714,395 value which the parties stipulated at trial. In any event, defendant did obtain the information it required before executing the contract with plaintiff. The NASA 1966 Renegotiation Performance Report noted, contrary to the inference defendant would have the court draw, that "* * * sufficient operating cost history was available from which to establish acceptable prices." Moreover, the report specifically mentioned that NASA had treated plaintiff's depreciation estimates with skepticism.

Defendant made no attempt to compare plaintiff's costs in prior years with its 1966 costs, arguing that the advent of the Super Guppy made such comparison irrelevant. The excerpt from NASA's renegotiation performance report quoted immediately above contradicts defendant's position.

Defendant's comparison of plaintiff's profits in 1966 with profits earned by plaintiff and plaintiff's predecessor in prior years is far too sketchy to assist the court in determining whether plaintiff's profits were abnormally high in the fiscal year under review. Defendant asserts that the profit figures recommended by defendant's expert were slightly lower than those for FYE August 12, 1965, as renegotiated. Like defendant's net worth comparison, this comparison is not useful because defendant does not explain how the 1965 figures are derived. It is impossible, therefore,

to know whether the 1965 rates of return provide a basis for valid comparison.

Defendant justifies the smaller percentage profit allowance recommended by its expert witness by arguing that risks assumed by Havenhurst during development of the Super Guppy were more substantial than those incurred when the Super Guppy was in actual contract operation. This contention is not supported by the record, which fails to suggest any measurable difference in the amount of risk during development of the Super Guppy as compared with operational risks during actual use.

Defendant explains that its expert witness could not compare plaintiff's cost and profits with those of other contractors because plaintiff was the sole source of oversize air transportation meeting NASA's requirements. To accept defendant's explanation of its failure to find relevant comparisons either in, for example, the air transportation or airframe manufacturing industry is to conclude that comparisons can never be made when a product or service is unique. 32 C.F.R. § 1460.2(c) (1974) does not take so limited a view of what comparative information is useful in renegotiation. The regulation specifies—

> In evaluating the contractor's performance, comparisons will be made with the prices, costs and profits of other contractors engaged in the production of the same *or similar* products or using the same *or similar* processes. [Emphasis added.]

The wording of the regulation is general enough to suggest the relevance of industry comparisons even when there is no identical product or service.[21]

Defendant's claim that industry comparisons were unavailable appears to rest upon a mistaken analogy drawn from antitrust law. In antitrust, the relevant market is the product market, whose outer boundaries, for the purpose of

[21] The Report of the Joint Committee on Internal Revenue Taxation Relating to Renegotiation, S. Doc. No. 126, 84th Cong., 2d Sess. 8 (1956), describing Renegotiation Board procedure, indicates that the Board relies upon "cost comparison with other firms where the same product is involved" and "relative profit to sales ratios of similar firms where there is no identical product."

assessing the extent of competition, are governed by the "reasonable interchangeability" of products and services offered for sale. *See Brown Shoe Co.* v. *United States*, 370 U.S. 294, 325 (1962). In renegotiation, however, where the focus is upon profit opportunities rather than upon the existence or absence of marketplace competition, the relevant markets are the markets for capital investment, risk taking, and entrepreneurial skill. The boundaries of these markets are necessarily wider than the boundaries of individual product markets, and meaningful comparisons can be made over a broader range.

NASA's 1966 Renegotiation Performance Report on plaintiff further undermines defendant's assertion that no industry comparisons were available to assess the reasonableness of plaintiff's profits. The report stated that although "[r]ealistic comparison of prices with competitors' prices cannot be made as contractor's aircraft is unique to other commercial and military cargo aircraft[, t]he per mile flight cost compares favorably with commercial and military rate experience assuming maximum flight schedule is experienced." The report noted in addition that NASA considered plaintiff to be an average cost producer during 1966. Since defendant has nonetheless chosen not to rely upon industry comparisons, this valuable source of comparative data is not available to the court as the basis for its decision.

Defendant is correct in asserting that the proportion of plaintiff's nonrenegotiable sales was so small—less than one thousandth of plaintiff's total sales in 1966—that plaintiff's profit on products and services not subject to renegotiation does not provide a meaningful basis for comparison in this case. Defendant is also correct in rejecting comparison of plaintiff's wartime profits, of which there were none, and peacetime profits.

32 C.F.R. 1460.10(b)(3) (1974) provides:

> Favorable consideration will be given to an increase in volume of production for defense purposes. On the other hand, when the Government's demand has enabled the contractor to increase his sales without exceptional effort and without corresponding increases in costs, decreased unit costs result, and the Government should

normally get the principal benefit *in more favorable prices, or in renegotiation.* [Emphasis added.]

The number of miles actually flown by plaintiff in 1966 was greater than the number of miles for which the contract guaranteed plaintiff it would be paid. Defendant's expert witness took this into account by recommending that plaintiff be allowed a lower rate of profit on the extra miles flown. The witness' stated rationale for this reduction was that the additional sales were, he assumed, not anticipated by the contracting parties and that plaintiff's overhead costs would not be increased by the additional miles flown. This analysis is faulty because it fails to take the applicable regulation, cited immediately above, into account.

The regulation provides that favorable consideration will be given when sales are increased to accommodate additional Government demand. Any such favorable consideration is subject to the proviso that the Government should get the principal benefit of decreased unit costs either in lower prices or in renegotiation. In this case, the Government has already reaped the benefit of reduced prices for additional miles flown because of the way contract NAS 8-15476 was originally negotiated.

The contract provided for 18,000 miles of guaranteed usage per month at an average rate of $12.92 per mile.[32] Miles flown in excess of the guarantee were to be compensated at the rate of $3.15 per mile for flights carrying freight and $3.05 per mile for return flights without cargo. Accordingly, the more miles plaintiff flew in excess of the guaranteed number of miles, the lower the unit cost to the Government would be. In 1966, plaintiff flew a total of 474,965 miles. By dividing $3,624,614, the total amount which plaintiff was paid for air transportation services in 1966 by the 474,965 miles flown, the court finds the average cost per mile to the Government to have been $7.63. A reduction in unit cost to the Government was, accordingly, built into NASA's contract with plaintiff. Defendant's witness did not explain why a further reduction in profitability *in addition to* the price reduction

[32] This figure is a weighted average, which takes into account the fact that monthly guarantee rates fluctuated during 1966.

provision written into plaintiff's contract with the Government is necessary to make plaintiff's profits nonexcessive.[33]

By presenting evidence respecting the character of its business, its contribution to the defense effort, the extent of risk assumed, and its efficiency, plaintiff has established a prima facie case within the meaning of the *Lykes* decision. In view of plaintiff's positive showing with respect to these statutory factors, combined with the lack of meaningful comparative information provided by either party under the source of capital and reasonableness of costs and profits statutory factors, it is not self-evident that plaintiff's 1966 profit of 28.85 percent of sales was excessive. Without more information, it is impossible to say that any particular amount of plaintiff's 1966 profits was excessive.

We now turn our attention to consideration of defendant's affirmative arguments that plaintiff did realize excessive profits.

Defendant's Case for Excessive Profits

In the *Lykes* case, this court held that once plaintiff has discharged its preliminary burden of going forward with proof as to the statutory factors upon which it relies, the burden shifts to the defendant to rebut the contractor's contentions and prove the extent of excessive profits realized. 198 Ct. Cl. at 326–27, 459 F. 2d at 1401–02.

Defendant assumed this burden at trial by presenting Mr. James E. Cravens, a contract manager and cost analyst employed by the Navy, as its sole witness. Mr. Cravens, a defense procurement expert, is a specialist in contract negotiation and pricing. Despite his impressive credentials in Government procurement as a contract manager and cost analyst, the witness considered himself neither an accountant nor an economist.

Defendant's expert testified that, in his opinion, plaintiff's profit of $1,132,940 during 1966 was excessive by $378,000 and that a reasonable profit would have been $754,940. After

[33] More fundamental difficulties with the profit analysis of defendant's expert are discussed *infra*.

adjustment, not made by defendant, on account of state taxes attributable to the nonexcessive portion of plaintiff's profits (32 C.F.R. §§ 1459.9(a), (b)(2) (1974)), plaintiff's profits would be $766,425, or 21.53 percent of plaintiff's adjusted sales. Mr. Cravens' recommendation exceeds the unilateral order of the Renegotiation Board by $129,917. The Board's order left plaintiff with adjusted profits of $896,342, or 24.29 percent of adjusted sales. As noted *supra*, plaintiff's actual 1966 return on sales was 28.85 percent.

Mr. Cravens based his opinion upon a *modified version* of the Weighted Guidelines Method, a procurement technique used by contracting officers of the Department of Defense (DOD) to establish profit objectives during contract negotiations. The manner in which the Weighted Guidelines are to be applied in a procurement situation is illustrated in Armed Services Procurement Regulation (ASPR) 3–808, 32 C.F.R. 3–808 (1974).

Briefly, contract performance is broken down into its different cost elements, such as materials, labor, general and administrative expense. Profit amounts are assigned to each element of cost. These amounts may vary, within a specified range prescribed by the weighted guidelines ASPR, depending upon the difficulty of procuring the material or the sophistication of the service provided. In addition, contractors may receive additional profit, computed as a percentage of their *total* costs of performance, for assumption of contract cost risk, quality of past performance, selected factors (source of resources and special achievement), and special profit consideration (development of new items without Government assistance).

In documenting his decision to allocate a particular percentage of profit to a given contractor input, a contracting officer must *explain in detail* why he assigned a particular profit increment to each element of contract cost. This requirement is intended to insure fairness to the contractor, make certain the public interest has been considered, and provide a basis for subsequent review.

The weighted guidelines do not purport to be a retrospective technique for determining the overall reasonableness of

a contractor's profits in a given fiscal year, but were designed primarily to aid contracting officers in negotiation. 32 C.F.R. 3.808–2(a)(1) provides:

> The weighted guidelines method provides contracting officers with (i) a technique that will insure consideration of the relative value of the appropriate profit factors described in 3.808–4 *in the establishment of a profit objective and the conduct of negotiations;* * * *. The contracting officer's analysis of these profit factors is based on information available to him prior to negotiations. * * * [Emphasis added.]

Plaintiff objects strenuously to Mr. Cravens' use of a method patterned on the weighted guidelines, charging that the technique results in retroactive cost-plus-a-percentage-of-cost contracting, which Congress forbade in the Armed Services Procurement Act of 1947, ch. 65, § 4(b), 62 Stat. 23, 10 U.S.C. 2306(a) (1970). That act states flatly: "The cost-plus-a-percentage-of-cost [CPPC] system of contracting may not be used." Plaintiff's objection on this ground to profit analysis based on the weighted guidelines is valid. The weighted guidelines themselves survive the charge that they are a form of CPPC contracting when used prospectively as an aid in contract negotiation. This is so because once the profit objective is set, the contractor cannot increase his profits by increasing his costs, as is possible under the proscribed cost-plus-a-percentage-of-cost system of contracting. However, use of a system based upon the weighted guidelines in *renegotiation* is fraught with danger. Renegotiation is necessarily a retrospective process. If a cost-based system of profit analysis were to be adopted by the court for renegotiation determination, contractors would be on notice that higher costs would yield the potential for greater allowable profits in renegotiation.

32 C.F.R. 1460.8(a) (1974) states that as a matter of general renegotiation policy—

> [r]easonable profits will be determined in every case by overall evaluation of the particular factors present and not by the application of any fixed formula with respect to rate of profit, or otherwise. *Renegotiation proceedings will not result in a profit based on the principle of a percentage of cost.* [Emphasis added.]

In his article entitled "The Renegotiation Act of 1951," Robert Braucher noted:

> [The] danger [of impairing incentives to efficient performance inherent in any form of profit limitation regime] was clearest when profits were fixed as a percentage of actual cost and there was a positive incentive to wasteful cost increases designed to increase the allowable profit.[34]

A particular danger of applying any cost-plus method of profit analysis in renegotiation is that rewarding efficient performance is a basic imperative of renegotiation law. Accordingly, the renegotiation process must be as free as possible from methods known to be detrimental to promotion of efficiency.

Defendant's use in this case of a method of analysis patterned on the weighted guidelines, a Department of Defense procurement technique, is suspect for a further reason. As plaintiff points out, defendant's expert witness noted in his pretrial statement that NASA studies in 1964 and 1965 had concluded that the "weighted guidelines" method for developing prospective profit amounts and rates was not suitable for NASA. The space agency observed that the formula approach applied to the broad scope of DOD procurement "* * * did not have coequal application to the generally one-of-a-kind programs in NASA." Mr. Cravens did not disagree with NASA's judgment in his pretrial statement, and nowhere did the statement suggest that the witness intended to rely on the weighted guidelines as the basis for his testimony. At trial, Mr. Cravens did not enumerate the reasons which led him, apparently, to change his mind. Nor has defendant demonstrated by any other evidence the relevancy of the weighted guidelines technique proposed by its expert witness or the impropriety of NASA's rejection of the weighted guidelines.

The witness testified that the weighted guidelines method was developed by the Logistics Management Institute and the Department of Defense "after looking at several thousand contracts during 1962 and 1964." He did not testify

[34] Braucher, *The Renegotiation Act of 1951*, 66 HARV. L. REV. 270, 271 (1952).

to the nature of the defense contracts upon which the weighted guidelines has been based, nor did he assess the relevance or comparability of those contracts to the unique oversize air transportation service provided by plaintiff.

As indicated, *supra*, the renegotiation regulations, Tax Court opinions, as well as scholarly comment, all emphasize the importance of making comparisons with a relevant industry. This court can insist upon no less.

Comments submitted to a Subcommittee of the House Committee on Government Operations by Lawrence E. Hartwig, then Chairman of the Renegotiation Board, explained:

> Under the Act contractors are renegotiated on an over-all, fiscal year basis, that is, the determination of excessive profits, if any, is applied to the aggregate renegotiable profits of a contractor. This does not mean, however, that the evaluation—the analytical process—preceding a Board determination is also conducted on aggregate lines. Quite the contrary. *If a contractor is active in diverse industrial fields, he is required to provide the Board with a separate statement of the costs and profits of each of his major activities, together with information sufficient to enable the Board to evaluate such activity separately under the statutory factors.*[35]

Defendant's expert admitted, in fact, that the weighted guidelines method would *not* provide an equitable means for establishing a rate of profit for plaintiff unless the actual weightings of 32 C.F.R. 3.808–4 (1974) were abandoned for higher percentages than those permitted by ASPR's weighted guidelines. The witness estimated that the weighted guidelines would be suitable without modification for only a third or a fourth of NASA contracts. For the rest, including the contract involved in this case, the method would be proper only if the weights were appropriately adjusted to reflect elements such as a contractor's exceptional contribution or extraordinary risk. In actual defense procurement, the profit figure chosen by the contracting officer *may not exceed the weighted guidelines percentage range.* At trial,

[35] *Hearings on Renegotiation Board Operations Before the Government Operations Subcomm. of the House Comm. on Government Operations*, 92d Cong., 1st Sess. pt. 2, Appendix at 42 (1971) [emphasis added].

defendant's witness proposed modifications, in his discretion, of the weighted guidelines profit percentages in order to reach an "equitable" result.

In *Bethlehem Steel Corp.* v. *United States*, 206 Ct. Cl. 122, 127, 511 F. 2d 529, 531, *cert. denied*, 423 U.S. 840 (1975), a case dealing with the weighted guidelines in a situation involving review of a decision of the Armed Services Board of Contract Appeals, the court referred to "the remedial effect of a guideline regulation, any regulation, as against the assignment of a 'roving absolutism' to a Contracting Officer in granting or denying escalation."

As an expert witness rather than an administrative official in the discharge of his duties, Mr. Cravens was not obligated to adhere to the weighted guideline regulation. But by deviating from the weight ranges prescribed in the ASPR, the defendant's witness not only, in effect, conceded the inapplicability of the weighted guidelines to this case, but also deprived the guidelines of their value as restraints on discretion. In an attempt to lend greater credibility to his testimony, the expert witness couched his personal conclusions in the same format as the weighted guidelines. In the *Bethlehem Steel Corp.* case, *supra*, the court warned against "reversion to * * * 'do it yourself guidelines' * * *" and stated the "implicit requirement * * * that the purported 'rule' should really have general application and not be just an attempt to influence a lawsuit." *Id.* at 128, 511 F. 2d at 532. This does not in itself imply that the conclusions of defendant's witness were incorrect, but only that the court must assess the testimony as the opinion of a single expert witness rather than as an application of a procurement regulation to the facts of this case.

The testimony of defendant's expert witness was based upon a hypothetical situation presented to the witness by counsel for defendant. The following inaccuracies in the facts of the hypothetical or in the witness' inferences drawn from it undermine the validity of the ultimate conclusions reached by the expert.

1. Mr. Cravens' conclusion that plaintiff did not provide air transportation services with more than ordinary efficiency failed to take into account the difficult operating conditions,

previously discussed, which rendered plaintiff's consistent meeting of delivery schedules a substantial accomplishment. Related testimony by defendant's expert witness that the conditions under which plaintiff performed oversize air transportation services for NASA during 1966 were normal for the performance of air transportation services is contrary to the weight of evidence in the record, which underlines the unique nature of the service provided by plaintiff.

2. The hypothetical presented to defendant's witness at trial greatly minimized the significance of plaintiff's contribution to the aerospace effort. In asking the witness to assume that delivery of S–IVB stages would not have been materially affected in the event that the Super Guppy could not have been used, defendant's counsel neglected to outline to the witness NASA's intensely felt need for the services of the Super Guppy in order to secure additional time for reliability testing and contingencies.

3. When asked at trial whether he had considered any losses incurred by plaintiff in performing contracts in other years similar to the contract being renegotiated, Mr. Cravens testified that according to information available to him, plaintiff did not sustain monetary losses in two prior periods. The witness did not discuss the implications of the 1965 structural accident which almost resulted in loss of the Super Guppy during flight testing.

To the extent the hypothetical situation presented to defendant's witness did not accurately characterize the service plaintiff provided to the Government in 1966, the probative value of the witness' testimony is diminished.

Despite the Government witness' stated preference for the weighted guidelines technique as a means of determining what would be a reasonable profit for plaintiff, his testimony indicated he did not use the method as an independent analytical tool. His reasoning, as he explained it at trial, gave the Board's determination a presumption of validity impermissible in a de novo proceeding in this court.

Defendant's expert witness illustrated his conclusion that a reasonable profit for plaintiff during 1966 would be $754,940 by reference to a table presented here in consolidated form:

TABLE I

Plaintiff's cost submission filed with Renegotiation Board		A		B		(C-1) Effect of sales over estimate		C	(C-2)
		Average profit rate	Amount	Maximum profit rate	Amount	75% of (b)	25% of (a)	Composite	75% (b) + 25% (a)
Material	$35,706	2%	$750	4%	$1,500	$1,130	$190	$1,320	3.7
Direct labor	$522,897	12	62,800	12	62,800	47,100	15,700	62,800	12.0
Direct operating espenses	$1,405,893	7.3	102,050	11.4	160,800	120,600	25,510	146,100	10.4
Fuel and oil	353,633	(2-	7,100)	(4-	14,150)			(12,390	3.5)
Insurance	118,930	(6-	7,100)	(8-	9,520)			(8,920	7.5)
Depreciation	316,257	(12-	38,100)	(23-	75,100)			(65,800	20.8)
Training/engineering	6,473	(15-	970)	(15-	970)			(970	15.0)
Other	610,600	(8-	48,780)	(10-	61,060)			(58,000	9.5)
General and administrative expenses	$500,378	7.9	39,450	10.2	51,800	38,850	9,860	48,710	9.7
Officers' salary	127,004	(10-	12,700)	(12-	15,250)			(14,620	11.5)
Other salary	84,344	(7-	5,900)	(8-	6,750)			(6,530	7.8)
Other expenses	289,030	(7-	20,850)	(10-	29,800)			(27,560	9.5)
Adjustment	$328,425	6	19,750	8	26,000	19,500	4,930	24,430	7.4
Cost of sales	$2,793,299	8.1	224,800	10.8	302,900	227,180	56,190	283,370	10.1
Risk/contract type		7.4	206,800	10.6	295,500	221,630	51,650	273,280	9.8
Performance		2.1	59,100	2.1	59,100	44,320	14,810	59,130	2.1
Exceptional contribution		7.9	220,440	7.9	220,440	139,160		139,160	5.0
Profit: *recommended* percentage and amount		25.5	711,140	31.4	877,940	632,290+	122,650	754,940	27.0
Refund due based on $1,132,940 realized			421,800		255,000			378,000	

Mr. Cravens identified the first column of the table as the "elements of cost presented by the contractor, to the renegotiation board." This column, with two significant exceptions discussed *infra*, accurately reflects plaintiff's stipulated 1966 costs.

The next column, A, Mr. Cravens described as "an average rate of most contractors in a service area, in performing a unique service for the Government." As noted above, Mr. Cravens did not testify to the nature of the services for which column A would represent an "average" rate of profit or relate the nature of those services to the type of service performed by plaintiff. Mr. Cravens did not offer specific explanation of why particular percentages of profit should be allowed on individual items of cost. For example, although he recommended that 8 percent profit be allowed on plaintiff's "Other Direct Operating Costs," he neither mentioned that these expenses included items as disparate as "aircraft crew per diem and travel expenses" and "repairs and maintenance," nor explained why an overall rate of 8 percent profit on expenses of this nature would be appropriate.

Mr. Cravens testified that column B, labeled "maximum profit rate/amount" represented approximately what the Renegotiation Board had concluded. The witness explained that he had been asked, sometime in August or September of the year preceding the trial—

> * * * to come up with a ballpark figure to determine if the renegotiation board's figures had included all of the elements of cost in the contractor's input, and to see what comparison would be made in that area.

Column B lacks documentation essential to give it stature independent of the Renegotiation Board's result. Although the witness referred to column B as a "ballpark figure," he did not relate any of the individual profit amounts appearing in column B to amounts allowable under the weighted guidelines for comparable inputs by other Government contractors. In fact, the impression conveyed by Mr. Cravens' testimony was that column B was created simply to explore what weighted guidelines profit percentages would be needed to generate a result close to that reached by the Board. This is brought out by the following circumstances:

(1) Early in his testimony, the witness described the weighted guidelines as "only a discipline to cover each item of the cost summation as made by the contractor" "to insure that every item of cost input for the contractor and all the contractor's performance, affecting the contract were considered;"

(2) A later colloquy between counsel for defendant and Mr. Cravens suggested that the witness worked backward from the Board's result to see what weighted guidelines percentages would correspond to the profit amount allowed the contractor in the Board's unilateral order.[36]

The *Lykes* decision clearly requires that the Board's determination of excessive profits be given no presumption of validity in a redetermination proceeding in this court. The testimony of Mr. Cravens strongly suggests that such an impermissible presumption insinuated itself into his excessive profit recommendation.

Column C, which summarizes Mr. Cravens' ultimate conclusion that plaintiff realized excessive profits in the amount of $378,000, is a composite of columns A and B. Mr. Cravens explained that he derived column C by adding 75 percent of the so-called "maximum profit rate" of column B to 25 percent of column A, the "average profit rate." This computation had the effect of weighting column B three times as heavily as column A and was designed by Mr. Cravens to correspond to the ratio of the dollar amount of plaintiff's guaranteed sales during 1966 to the dollar amount by which actual sales exceeded the total amount of monthly guarantees.

Column C, as a composite of columns A and B, is subject to the infirmities of the data from which it was derived. Column C, which provided the basis for Mr. Cravens' conclusion that plaintiff owes the United States $378,000 in excessive profits, is merely a weighted average of two other unsubstantiated profit recommendations.

This defect was not cured at trial by Mr. Cravens' explanation of the column C figures, upon which he based the

[36] "Q. So, * * * [column B] represents approximately what the Renegotiation Board gave and then this column was a result of the Justice Department's asking you to find out if what the Renegotiation Board gave as a proper—a reasonable profit was a ballpark figure, is that correct?

"A. *Yes*, and that would be assuming the maximum value for the performance, and each element of input and each item below the line * * *." [Emphasis added.]

remainder of this testimony. For example, Mr. Cravens testified that the $59,130 which he recommended as profit to reward plaintiff's performance under contract NAS 8–15476 represented a return of 2.1 percent on plaintiff's total costs in performing the contract and exceeded the weighted guidelines maximum of 2 percent. Apart from his earlier general statement that the weighted guidelines method would not provide an equitable means for establishing a rate of profit for plaintiff unless the actual weightings of ASPR 3–808.4 were abandoned in favor of higher percentages, defendant's witness failed to explain why he chose a figure in excess of the weighted guidelines percentage or why, for that matter, he did not regard a *higher* profit to be warranted by the contractor's performance.

Another example is Mr. Cravens' allocation of a 9.7 percent profit to plaintiff's general and administrative expenses, a percentage which exceeded the maximum rate of 8 percent provided in the weighted guidelines ASPR. The witness testified that the higher profit allowance was necessary in order to recognize the performance of plaintiff's officers in insuring that the air transportation services met the NASA schedule, maintaining plaintiff's cash flow, and supervising activities of the relatively new corporation. He did not explain what type of corporate performance the weighted guidelines contemplated as necessary to justify the 8 percent maximum, or why plaintiff's performance justified a more liberal profit award.

The Government witness' recommendation of a profit amount to be assigned under his adjusted weighted guidelines technique to plaintiff's depreciation expense is another significant example of an inadequately explained profit recommendation. Depreciation is the element of cost for which Mr. Cravens felt the greatest deviation from the weighted guidelines was justified. The witness assigned a 20.8 percent profit to plaintiff's depreciation expense, almost three times the weighted guidelines amount. He explained his rationale for doing so as follows:

> * * * Since we were looking at [the contractor] in hindsight, and since Internal Revenue in hindsight had changed depreciation methods, I wanted to reinstall the

amount of money, or a certain amount of it, that had been taken away by Internal Revenue [in] going from four years to five years [as the depreciable life of the Super Guppy and Pregnant Guppy for tax purposes].

I put that back in here by giving a high rate for depreciation. * * *

The Internal Revenue Service action to which Mr. Cravens referred was based upon the Service's judgment that a 5-year depreciable life was more realistic than the 4-year life originally chosen by the plaintiff. Neither party has questioned this I.R.S. decision. In fact, the record shows that the $663,280 in "current year [tax] depreciation expense," listed in plaintiff's revised table of physical assets,[37] already reflects the $152,467 I.R.S. disallowance of tax depreciation expense for 1966 based upon the change in depreciable life of the Guppy aircraft.

Mr. Cravens did not explain why he chose, in effect, to modify the I.R.S. decision to disallow part of plaintiff's tax depreciation. As noted, *supra*, this court will exercise its discretion to redefine costs taken for tax purposes only to correct material misstatement of a contractor's cost of doing renegotiable business. No clear showing of such misstatement is present here.

By treating $316,257 as the correct amount of plaintiff's depreciation, the Government witness made an additional error. The $316,257 figure was obtained by subtracting $152,467, the full amount of the *tax* depreciation disallowed for 1966, from $468,724, plaintiff's book depreciation. Plaintiff's accounting submission, to which the parties stipulated, placed plaintiff's 1966 tax depreciation expense at $663,280. As noted, *supra*, this figure had already taken into account the I.R.S. depreciation disallowance, in which plaintiff concurred. Therefore, the depreciation amount relevant for renegotiation purposes is $663,280, not the materially smaller and factually incorrect $316,257 used by defendant's witness. Nowhere in his testimony did defendant's witness acknowledge the distinction between *tax* deductions, which are rele-

[37] The table is included in the accounting submission to which the parties stipulated before trial.

vant for renegotiation purposes, and *book* depreciation, which generally is not.

A further, serious discrepancy in Mr. Cravens' treatment of plaintiff's depreciation expense arose from his apparent failure to appreciate the distinction between tax and book depreciation. Plaintiff's 1966 tax depreciation of $663,280 exceeds its book depreciation of $468,724 by nearly $200,000.[38] To reflect the difference in amount between plaintiff's allowable tax depreciation and its book depreciation, the standard form contractor's report for renegotiation, which plaintiff was required to submit to the Board,[39] included an entry labeled "Adjustment from Books to Tax Basis." This adjustment was comprised almost exclusively by the difference between plaintiff's tax and book depreciation.

As noted, *supra*, tax rather than book depreciation is relevant for renegotiation purposes, absent special circumstances not present in this case. Accordingly, the $663,280 depreciation figure is the relevant one, not the $316,257 the Government witness erroneously regarded as the correct amount of plaintiff's depreciation expense. Perhaps as the result of this error, the witness assigned 20.8 percent profit to the $316,257 amount, while allowing only 7.4 percent profit on plaintiff's "Adjustment from Books to Tax Basis." As noted above, the adjustment *must* be added to the correct amount of plaintiff's book depreciation in order properly to state the amount of plaintiff's tax depreciation.

Defendant did not challenge the correctness of the tax depreciation amount accepted by the I.R.S. Therefore, it is reasonable to expect that, absent some explanation not present in the testimony of defendant's witness, the same profit percentage should be applied to both the depreciation figure listed under plaintiff's "direct operating expenses," [40] and the correct "Adjustment from Book to Tax Basis," both of which are indispensable elements of the proper tax depreciation total.

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[38] Before adjustment by the I.R.S. of plaintiff's tax depreciation to take account of the extension of the depreciable life of plaintiff's aircraft, this difference was approximately $330,000.

[39] This form was introduced into evidence as part of plaintiff's accounting submission.

[40] This figure should be increased by $152,467 to $468,724, as explained *supra*.

Mr. Cravens' testimony, which recommended two highly disparate profit rates for the two elements of the same tax depreciation total, gave no indication that the witness was aware of this anomaly in his reasoning.

A further circumstance which seriously undermines confidence in Mr. Cravens' explanation of his column C results is that the "exceptional contribution" item in that column contains an $81,280 arithmetic mistake. Column C–1 is in effect a worksheet which shows how the composite figures of column C were derived. For every element of columns A and B, except "exceptional contribution," computations were carried out according to the 75 percent–25 percent formula. Without any explanation, Mr. Cravens failed to make a similar computation for "exceptional contribution." Taking this into consideration, the correct figure which should appear as the next to last entry in column C is $220,440. This is $81,280 more than the $139,160 which actually appears. Making this correction results in diminishing the final recommended refund from $378,000 to $296,720 (before adjustment for taxes) and increasing defendant's recommended profit to $836,140 or 29.93 percent of cost.

Despite this significant error, at trial Mr. Cravens presented the column C "reasonable profit" figures as the foundation for his ultimate profit conclusion. He treated his $378,000 excessive profit recommendation as completely valid notwithstanding the $81,280 arithmethic error. Even if Mr. Cravens' explanation of how he developed his column C figures had been persuasive, the $81,280 correction would need to be made.

Defendant's witness developed profit amounts to be awarded under each of the statutory factors for renegotiation by reshuffling the profit amounts in column C of his adjusted weighted guidelines table.

For example, profit amounts from Table I which Mr. Cravens felt could be assigned as components of the profit which he felt should be awarded for the contractor's efficiency included:

1. $59,130 recommended by Mr. Cravens to reward the contractor's "performance" under the weighted guidelines;

2. $62,800 to reward the contractor's "direct labor" activities; and

3. $48,710 as a profit increment on plaintiff's general and administrative expenses.

Mr. Cravens' total recommended award for plaintiff's efficiency was $170,640.

To derive a recommended profit attributable to the reasonableness of the contractor's costs and profits, Mr. Cravens assigned $136,640, which appeared in Table I as one-half the profit the witness felt should be awarded to recognize the contractor's risk in performing the NASA contract.

The $66,250 ascribed as profit to net worth and source of capital employed by the contractor was an aggregate of:

1. $32,900, or one-half the profit assigned under the adjusted weighted guidelines to plaintiff's depreciation cost;

2. $8,920 assigned as profit to plaintiff's insurance expense; and

3. $24,430 assigned as profit to plaintiff's "adjustment from book to tax basis" reflected on its accounting statement for renegotiation.

The witness assigned $169,540 profit to the risk assumed by the contractor. He compiled this figure by adding $136,640, the other half of the profit he had allocated to plaintiff's risk in his adjusted weighted guidelines table, to $32,900, the other half of the weighted guidelines amount he had assigned as profit to plaintiff's depreciation cost.

To recognize plaintiff's contribution to the space effort (defense effort), Mr. Cravens allowed $139,160, the *incorrect* column C figure he had assigned to plaintiff's "exceptional contribution" under the weighted guidelines.

The $72,680 assigned by the Government witness to recognize the *character of plaintiff's business* was simply an amalgam of weighted guidelines profit amounts Mr. Cravens had not used elsewhere. These included:

1. $1,320 assigned as profit on plaintiff's materials costs;

2. $12,390 allowed on plaintiff's fuel and oil expenses;

3. $58,000 assigned to plaintiff's "other" expenses; and

4. $970 profit on plaintiff's engineering and training expenses.

These figures totaled $754,940, the total profit recommended by Mr. Cravens.

As noted previously, the effect of this manifestly artificial technique was simply to reassign profit amounts derived pursuant to Mr. Cravens' modified version of the weighted guidelines to the statutory factors enumerated in the Renegotiation Act. However, because his profit recommendations were derived in such a roundabout manner, the witness did not justify his recommendations by explicit reference to the statutory factors *as set out in the Renegotiation Act.*

To sum up, the Government's witness' testimony indicated defendant's own lack of confidence in the applicability of the unmodified weighted guidelines procurement device to the renegotiation case under consideration. This lack of confidence, combined with the wholly inadequate explanation given by defendant's expert of the profit percentages he recommended instead of the weighted guidelines profit levels, left the court with insufficient information upon which to base a *reasoned* evaluation of the reasonableness of plaintiff's profits. The court simply cannot state with any degree of certainty if plaintiff's profits were excessive and, if they were, by how much. Accordingly, defendant has not met its burden of persuasion on either of these issues.

If a procurement officer were to use only the maximum figures recommended in the weighted guidelines ASPR, he would have recommended a profit of $542,321.50 for plaintiff. The $754,940 profit figure recommended by defendant's witness is 132 percent of the weighted guidelines maximum. The correct figure, $836,240, which eliminates defendant's arithmetic error, is 146 percent of the weighted guidelines maximum. The $1,132,940 profit actually realized by plaintiff is 197 percent of the weighted guidelines maximum. The testimony of defendant's witness, taken as a whole, failed to establish with any degree of assurance that his recommended profit allowance midway between the weighted guidelines maximum and the profit actually received by plaintiff was any more than a compromise solution.

As stated in *Bethlehem Steel Corp.* v. *United States*, 191 Ct. Cl. 141, 154, 423 F. 2d 300, 307 (1970), it would be improper for the court to make a determination under the weighted guidelines—or any variation on them—when the record is inadequate. "To use the method one needs to be well informed." This is no less true now than it was then. If a de novo redetermination of excessive profits in the Court of Claims is to have meaning, the court must have enough information at its disposal to render a confident decision. The court must be the ultimate fact finder in the case, and no witness can relieve the court of its obligation. The testimony of witnesses must provide the court with the information it needs to render a just decision. As is correctly explained in MCCORMICK's text on EVIDENCE—

> * * * [t]he purpose of the testimony has had an effect on the degree of concreteness required. In the outer circle of collateral facts, near the rim of relevancy, evidence in general terms will be received with relative freedom, but as we come closer to the hub of the issue, the courts have been more careful to call for details instead of inferences. * * *
>
> * * * * *
>
> Undoubtedly there is a kind of statement by the witness which amounts to no more than an expression of his general belief as to how the case should be decided or as to the amount of unliquidated damages which should be given. It is believed all courts would exclude such extreme expressions. There is no necessity for this kind of evidence; to receive it would tend to suggest that the judge and jury may shift responsibility for decision to the witnesses * * *.

C. MCCORMICK, EVIDENCE § 12, at 26 (2d ed. 1972).

While the preceding discussion is couched in terms of admissibility, it is relevant also to the amount of weight the court may give to testimony while preserving its own function to hear and decide.

Accordingly, defendant has failed to provide the court with evidence sufficient to enable it to determine what portion, if any, of plaintiff's profits realized during 1966 was excessive.

After careful consideration of all the facts, the statutory factors, and the submissions of the parties, it is concluded

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that defendant has failed to sustain its burden of proving that plaintiff has realized excessive profits and of showing the amount of such excess. While it is not altogether clear from the record, it does appear that plaintiff has paid the amount of the excessive profits as determined by the board to defendant. Therefore, plaintiff is entitled to a refund of the amount paid with interest as provided by the Renegotiation Act of 1951, *as amended.*

CONCLUSION OF LAW

Upon the findings of fact which are made a part of the judgment herein, the court concludes and determines as a matter of law that defendant has failed to sustain its burden of proving that plaintiff has realized excessive profits and of showing the amount of such excess, and it is accordingly ordered that plaintiff is entitled to a refund of the amount paid to defendant, together with interest as provided by the Renegotiation Act of 1951, *as amended.*

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530 F. 2d 878

C. H. LEAVELL AND COMPANY v. THE UNITED STATES

[No. 91–74. Decided January 28, 1976]

ON PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT AND DEFENDANT'S CROSS-MOTION FOR SUMMARY JUDGMENT AND MOTION TO DISMISS COUNT II

Contracts; delays; equitable adjustment; Suspension of Work clause v. Funds Available for Payment clause; "continuing" contract.— On May 5, 1967 under authority of the River and Harbor Act of 1960, plaintiff was awarded a unit-price "continuing" contract for construction of the Jonesville Lock and Dam in Louisiana, to be completed within approximately three years from receipt of notice to proceed, plaintiff being liable for liquidated damages for each day of unexcused delay beyond the completion date. The contract was subject to Funds Available for Payment clause (SP–19 clause) providing that the Government would not be liable for damages on account of delay in payment due to lack of appropriated funds. As the result of an appropriation curtailment in a later year, funds were exhausted and work was suspended from January 14 to June 16, 1969. Plaintiff seeks an equitable adjustment for its added costs

Syllabus

pursuant to the Suspension of Work clause. The Engineering Board of Contract Appeals, in denying an equitable adjustment, reasoned that plaintiff did not incur its loss without its own "fault or negligence" since despite the inclusion of the SP–19 clause in the contract and plaintiff's knowledge that it would exhaust the funds available for contractual progress payments, it followed an "accelerated schedule," whereas, according to the board, it should have decelerated, and therefore the Suspension of Work clause by its own stated limitations did not apply. At the time of suspension, plaintiff was behind a progress schedule defendant had agreed to, subject only to funds availability. The board found that the accelerated schedule plaintiff tried to adhere to would, if uninterrupted, have produced "optimum profits." It is *held* that plaintiff is entitled to an equitable adjustment under the Suspension of Work clause for an unreasonable suspension even though the cause is an appropriation cutoff, whose possibility the parties contemplated and whose consequences are dealt with under SP–19, and even though the Government officers acted reasonably in allocating the restricted funds available between plaintiff's contract and other claimants against the same appropriation project. A suspension of work under the Funds Available for Payment clause is one for the convenience of the Government within the intendment of the Suspension of Work clause. Judgment is entered for plaintiff and the cause is remanded to the board for proceedings to ascertain the quantum of equitable adjustment to which plaintiff is entitled. Proceedings in this court are stayed for 6 months.

Contracts; Funds Available for Payment clause; generally.

[1] The Funds Available for Payment clause, mandatory in Army Corps of Engineers "continuing" contracts, reads to assure a contractor of an extension of time in case of an entire work stoppage due to exhaustion of funds, but is silent as to a deceleration made *sua sponte* by a contractor subject to imposition of liquidated damages for unexcused delay because of the contractor's anticipation that funds would run out.

United States ⇐ 75(5)

Contracts; performance; continuing contract; Funds Available for Payment clause; deceleration of work.

[2] Government officers in administering a "continuing" construction contract subject to a Funds Available for Payment clause have ample authority to order a deceleration of work under the standard Changes and/or Suspension of Work clauses if they think such action will make the consequences of an anticipated stringency of funds less painful than a later total work stoppage. It is wholly arbitrary and capricious to accuse a contractor of "fault or negligence" under the Suspension of Work clause limitation because it did not initiate a decelerated schedule on its own, without orders.

United States ⇐ 73(23)

Syllabus

Contracts; Funds Available for Payment clause; allocation of funds to individual contracts.

[3] The Funds Available for Payment provision in a "continuing" contract means that where the agency authorized to spend the appropriation allocated the funds on a rational and non-discriminatory basis between all claimants against the same appropriation project and the funds prove insufficient, the Government is not liable for harm resulting from the shortage.

United States ⟸ 73(23)

Contracts; disputes; administrative decision; finality of on question of law.

[4] A decision of the board of contract appeals based on conflict between two contract clauses involves a question of law which this court is free to decide for itself regardless of the board's decision.

United States ⟸ 73(12)

Contracts; interpretation; contract as a whole; clauses construed together.

[5] Contract provisions should not be construed as conflicting unless no other reasonable interpretation is possible.

United States ⟸ 70(4)

Contracts; delays; equitable adjustment; Funds Available for Payment clause v. Suspension of Work clause.

[6] The exculpatory language in the Funds Available for Payment clause that the Government is not liable for damages on account of delay in payment due to lack of appropriated funds applies only to damages for breach of contract and does not apply to an equitable adjustment for unreasonable delays contemplated by the Suspension of Work clause. A suspension of work under the Funds Available for Payment clause is one for the convenience of the Government within the intendment of the Suspension of Work clause. Such a suspension is clearly designed to keep the contractor available for a period of time after exhaustion of funds while the agency awaits either additional funding or from discretionary allocation of already appropriated agency funds, and the contractor is entitled to an equitable adjustment for its additional costs incurred while in stand-by status unless through clear and specific language that risk is allocated to the contractor alone. While a contractor operating under a contract containing both clauses must realize that he bears the risk of suspension for lack of funds even though his work progress is current, under a fair reading of the two clauses he would not be alerted that he bears the additional risk of enduring a long suspension of work under an approved schedule without reimbursement for his stand-by costs.

United States ⟸ 73(23)

Per Curiam

Contracts; interpretation; contract as a whole; clauses construed together; Funds Available for Payment clause and Suspension of Work clause.

[7] When prospective Government contractors are evaluating their risks for contingency bidding purposes, they should be precisely informed as to where all contractual risks are allocated. Accordingly, under the subject "continuing" contract, the Funds Available for Payment clause and the Suspension of Work clause should be harmonized so as not to defeat both reasonable and legitimate expectations of the contractor, particularly since the former clause could have easily been worded to specifically preclude any equitable adjustment under the Suspension of Work clause for a suspension delay attributable to a funding shortage.

United States ⇐ 70(12)

William J. Derrick, attorney of record for plaintiff. *Kemp, Smith, White, Duncan & Hammond*, of counsel.

Edward J. Friedlander, with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Charles M. Reifel, for Associated General Contractors of America, amicus curiae. *Hudson, Creyke, Keohler, Brown & Tacke*, of counsel.

Before DURFEE, *Senior Judge*, NICHOLS and KASHIWA, *Judges*.

PER CURIAM: This case comes before the court on plaintiff's and defendant's requests filed July 7 and 10, 1975, for review by the court of the recommended decision filed on May 13, 1975, by Trial Judge Lloyd Fletcher, pursuant to Rule 166(c), and the parties' responses thereto. He reviewed and would reverse a decision of the Corps of Engineers BCA No. 3082, 73-2 BCA ¶ 10,349. The case has been submitted to the court on the briefs of the parties and oral argument of counsel. We have also had the benefit of amicus briefing and oral argument by the Association of General Contractors. Upon consideration thereof, since the court agrees with the said recommended decision, as hereinafter set forth, it hereby affirms and adopts the same as the basis for its judgment in this case.

The Army Engineers awarded plaintiff a long-term construction contract without having appropriated funds available for obligation in the full contract amount, as they are

authorized to do by 33 U.S.C. Sec. 621. As the result of an appropriation curtailment in a later year, funds were exhausted and work had to be suspended from January 14 to June 16, 1969. Plaintiff claims an equitable adjustment for its added cost, pursuant to the "Suspension of Work" clause, GP–42, a standard provision. Defendant denied and here denies liability because of the "Funds Available" clause SP–19, which is also standard in Army Engineers contracts of a continuing nature. We agree with plaintiff, the Association of General Contractors, and the trial judge, that an equitable adjustment is available under GP–42 for an unreasonable suspension even though the cause is an appropriation cut-off, whose possibility the parties contemplate and whose consequences they deal with under SP–19. This conclusion obtains even though defendant's officers acted reasonably, as the trial judge held they did, in allocating the restricted funds available between plaintiff's contract and other claimants against the same appropriation item. Plaintiff, in requesting review, urges they acted unreasonably, an issue we find unnecessary to reach in the circumstances.

The Board reasoned that plaintiff did not incur its loss without its own "fault or negligence" and therefore the Suspension of Work Clause by its own stated limitations does not apply. The Board considered that plaintiff followed an "accelerated schedule" in spite of full knowledge it would exhaust the funds available for contractual progress payments, on which it relied for working capital to keep the work going. It properly should have decelerated, says the Board. Actually, at the time of suspension, plaintiff was behind a progress schedule defendant had agreed to, subject only to fund availability. Defendant repeatedly had given notice that funds were about to run out and just as repeatedly, until the final occasion, it found more money somewhere. There is no evidence these notices were intended to give plaintiff a factual basis for planning a decelerated work schedule, nor were they in any way helpful for that purpose. Plaintiff gave notice in its letter of July 23, 1968, that it was unable to plan a deceleration. The Board finds the schedule plaintiff tried to adhere to would, if uninterrupted, have produced "optimum profits", an inverse way of finding

that a declerated schedule would have been more costly. The "Funds Available" clause reads to assure a contractor of an extension of time in case of an entire work stoppage due to exhaustion of funds, but says nothing as to a deceleration made by the contractor *sua sponte* because of his anticipation that funds would run out. If a contractor voluntarily decelerated, and then the Engineers found still another untapped financial resource, *quaere* whether any extension would have been available against the substantial liquidated damages the contract called for.

A construction contractor, such as the plaintiff, may be knowledgeable about the Engineers' financing, but is hardly likely to be as much so as the Engineers themselves. If they in their best judgment think a deceleration of work will make the consequences of an anticipated stringency of funds less painful than a later total stoppage, they have ample authority to order one under the Changes and Suspension of Work Clauses, either or both. We think it wholly arbitrary and capricious to accuse a contractor of "fault or negligence" because it does not initiate a decelerated schedule on its own, without orders. The most it might be expected to do is recommend or request deceleration orders, if it sees clearly that deceleration will be more economical than complete stoppage for a shorter period. No such possibility is shown here. By the standards of the Wunderlich Act, 41 U.S.C. Secs. 321, 322, the position of the Board cannot be sustained.

Nothing we say should be read as holding that an unordered deceleration is not a constructive partial suspension of work if made under pressure of compelling circumstances for which defendant is responsible. We are not here considering whether plaintiff would have had a claim for partial suspension of work under GP–42 if it had decelerated as the Board says it should have done. *Cf. Merritt-Chapman & Scott Corp.* v. *United States*, 192 Ct. Cl. 848, 429 F. 2d 431 (1970).

Therefore, judgment is entered for plaintiff and the cause is remanded to the Board, under Rule 149, for proceedings to ascertain the quantum of equitable adjustment to which plaintiff is entitled. Further proceedings in this court are stayed for six months. Counsel for plaintiff is designated

to advise the court of the status of proceedings as required by Rule 149(f).

The opinion and conclusion of law of the trial judge follow:

FLETCHER, *Trial Judge:* In this contract case the court is called upon for the first time to explore the interrelationship between two standard Government contract provisions which are included most frequently in so-called "continuing contracts". The two clauses are generally referred to as "Funds Available for Payments" (hereinafter frequently called the "funds available clause"), and "Price Adjustment for Suspension, Delays, or Interruption of Work" (hereinafter frequently called the "suspension of work clause").[1] The objective facts do not appear to be in significant dispute although the parties vary widely in their interpretation and application of those facts to the problem at hand.

The contract involved is a unit-price "continuing contract" which the Army Corps of Engineers awarded to plaintiff C. H. Leavell and Company (Leavell) on May 5, 1967. It called for the construction of the Jonesville Lock and Dam on the Black River in Catahoula Parish, Louisiana, for the sum of nearly $15 million. This construction was part of an overall navigation project authorized by Congress in the River and Harbor Act of 1960 for the improvement of the Ouachita and Black Rivers in Arkansas and Louisiana. The work was to be completed within 1,100 days, or approximately three years, from receipt of notice to proceed, and the contractor was subject to liquidated damages of $600 for each day of unexcused delay beyond the completion date. The contract provided for monthly progress payments to be made on estimates approved by the Contracting Officer, less a 10 percent retention by the Government until completion and acceptance of the work. A Notice to Proceed was received by Leavell on June 15, 1967, which fixed the completion date at June 17, 1970. Meanwhile, as a result of several contract modifications, the estimated contract price was increased to

[1] These two standard provisions, as included in the contract here involved, are known in Government contract shorthand nomenclature as SP–19 and GP–42, respectively. Inclusion of both is mandatory in Army Corps of Engineers continuing contracts. They are reproduced in full below as Appendix A hereto.

$15,029,782.31, with the completion date being slightly extended to June 19, 1970.

On June 23, 1967, Leavell had submitted a progress chart, as required by the contract, showing a completion date in December 1969, which was approximately two and one-half years after receipt of the Notice to Proceed. This progress chart, however, was rejected by the Corps of Engineers and was returned to Leavell with instructions that it be changed to reflect a progress curve through the scheduled completion date of June 19, 1970. Leavell revised and resubmitted the progress chart on July 20, 1967, in which the progress curve was duly extended through the completion date but continued to show a 96 percent completion within two years as had been shown in the original chart. This revised work schedule was approved by the Corps on August 14, 1967, "subject to the availability of funds as mentioned in SP–19 of the contract."

After encountering some delay in its concrete pile driving operations, Leavell submitted to the Corps in February 1968 a further revision of its program schedule. In this revision, the program curve was reshaped so as to show an 89 percent completion in two years with earnings at the end of fiscal year 1969 of about $13,350,000. According to Leavell's Project Manager, no action was taken by the Contracting Officer by way of either approving or disapproving this later revision.

The invitation for bids on the Jonesville Lock and Dam contract specified that only $25,000 was then available. At the time of the award to Leavell, however, this sum had been increased to $75,000, and Leavell was advised to that effect. Thereafter, funds for the contract were increased on July 10, 1967, to $2,915,000, and were later increased on January 22, 1968, to $3,496,900. On March 13, 1968, however, the Contracting Officer wrote Leavell as follows:

> A review of your construction progress indicates that the funds available for expenditure under this contract will be exhausted about 15 April 1968. Therefore, in accordance with the provisions of paragraph SP–19e of the contract specifications, this is your notice that funds available are only sufficient to pay for your estimated

earning through about that date and work may be suspended when funds are exhausted.

At your option, and as provided in paragraph SP–19e, you may continue work under this contract after funds are exhausted, as we have sufficient funds for inspection and supervision through 30 June 1968. However, no payments will be made for such work unless additional funds become available. When funds again become available, we will notify you promptly.

Should work be thus suspended, additional time for completion will be allowed equal to the period during which work is necessarily so suspended, as provided in paragraph SP–19e.

Nonetheless, on March 21, 1968, and March 28, 1968, funds were increased for a total of $500,000, on which occasions the Contracting Officer advised Leavell that he had anticipated the receipt of such additional funds even at the time he had issued the above-quoted notice of deficiency. Thereafter, the same procedure was followed and by June 29, 1968, funds had been increased to $4,733,300.

Then, on July 9, 1968, at which point Leavell had completed about 39 percent of the job, the Contracting Officer wrote Leavell as follows:

> I have increased funds to $6,083,300.00 for the payment of estimates of work * * * for construction of Jonesville Lock and Dam.
>
> The additional funds provided herein should not be construed as the total that will be made available in FY 1969. The President's FY 1969 Budget contained $5,656,000 for this contract and the House passed FY 1969 Appropriation Bill for FY 1969 contained $4,712,000.00. However, because of the pending cut in FY 1969 Federal Expenditures, the full amount available for the year will not be known until final appropriations are made.

During the preceding month, the Revenue and Expenditure Control Act of 1968 had been enacted, and Leavell's president realized that this Act, which contained a ceiling on Government expenditures for 1969 of $6 billion below the budget sent to Congress on January 29, 1968, might have an impact on the funding of the project. In implementation of the Act, the Bureau of the Budget established expenditure ceilings for individual agencies and required each agency

to prepare and maintain a financial plan with a view to controlling Government obligations so as to permit effective adherence to the expenditure ceiling thus imposed.

At this time, Leavell considered slowing down the work. However, upon considering the possibility that any such deceleration might cause it to exceed the completion date and hence become liable for liquidated damages at the rate of $600 a day, Leavell decided to proceed with the work in accordance with the planned rate of progress. On July 23, 1968, Leavell's project manager wrote the following letter to the Contracting Officer:

> We are in receipt of your letter dated 9 July regarding the above subject, and are considerably dismayed at its contents, although it is our understanding that the amounts set forth therein may yet be final.
>
> We have made a thorough review of our proposed progress for the current fiscal year and a conservative evaluation indicates that we will perform work amounting to approximately $6.5 million between now and 30 June 1969. Further during this progress review, we were unable to practically design a rate of progress commensurate with the funds which you indicated will be available.
>
> The situation appears very serious to this company and we would appreciate your thinking and any further information which you may be able to furnish.

In response to the above letter, the Contracting Officer advised Leavell that he could not comment on the adequacy of funds to meet the progress schedule until the FY 1969 Appropriation Bill was passed.

The FY 1969 Civil Work Appropriation Act was enacted in August 1968. The Bureau of the Budget, however, had as yet not implemented the Revenue and Expenditure Control Act. It was not until some time in September 1968 that the Corps received a spending ceiling for FY 1969 expenditures from the Bureau of the Budget, and it was not until October 1968 that the Corps-proposed plan of meeting its ceiling was approved by the Bureau of the Budget.

By letter dated September 6, 1968, the Contracting Officer increased the allocation of funds to plaintiff's contract to a total of $7,483,300. On September 25, 1968 the Contracting

Officer by letter again increased the funds allocated to Leavell's contract to a total amount of $9,233,000. No additional funds were thereafter obligated against plaintiff's contract until June 1969 when the allocation of funds to the contract was increased by $715,000.

On November 29, 1968, the Contracting Officer, pursuant to the "Funds Available for Payment" clause, notified Leavell as follows:

> Review of your construction progress indicates that the funds available for expenditure under this contract will be exhausted about 31 December 1968. Therefore, in accordance with the provisions of paragraph SP–19 of the contract specifications, this is your notice that funds available are only sufficient to pay for your estimated earnings through about that date and work may be suspended when funds are exhausted.
>
> At your option, and as provided in paragraph SP–19e, you may continue work under this contract after funds are exhausted, as we have sufficient funds for inspection and supervision through 30 June 1969. However, no payments will be made for such work unless additional funds become available. When funds again become available, we will notify you promptly.
>
> Should work be thus suspended, additional time for completion will be allowed equal to the period during which work is necessarily so suspended, as provided in paragraph SP–19e.

By letter dated December 14, 1968, Leavell advised the Government that:

> * * * upon exhaustion of funds presently available to us shortly after 1 January 1969, C. H. Leavell & Company will suspend all operations on the Jonesville Lock and Dam project.
>
> Be further advised that we intend to claim for all costs incurred as a result of this suspension of work, under the applicable articles of the contract * * *

Work was in fact suspended by Leavell on January 10, 1969. At that time the work was about 58 percent completed and the sum of $9,233,300 had been obligated against the contract.

In response to a request by Leavell on January 14, the Contracting Officer wrote a letter to Leavell in which he reviewed the various budgetary factors and expenditure

restrictions under which the Corps of Engineers was operating during FY 1969. He reminded Leavell that under the terms of its contract there was no "absolute guarantee that funds will be made available in the future to continue the project," but at the same time, observed that it was the history of such projects for Congress to provide appropriate funds for continuation of projects in such an advanced state of completion. He concluded the letter with the rather superfluous statement:

> Consequently, my position is that expressed in my letter of 29 November 1968, advising you of the exhaustion of funds and as further expressed in paragraph SP–19 of your contract, referred to in that letter.

During the shutdown period, considerable materials and equipment had been delivered to the project site, and on May 27, 1969, the Government advised Leavell that approximately $800,000 would be available at July 1, 1969 to pay for previously delivered materials and equipment. Leavell responded that material and equipment worth approximately $640,000 would be delivered to the site prior to June 20 for which it would expect payment no later than July 1 and that it was not in any way relinquishing its claim for suspension of the work.

On June 5, 1969, the Contracting Officer advised Leavell that additional funds in the amount of $715,000 would be obligated to the contract on or about June 11, and that this would enable Leavell to resume construction work. Leavell responded that it would recommence work on June 16, 1969. From all that appears, the work was thereupon resumed and carried to completion without further dispute.

Before the Corps of Engineers Board of Contract Appeals, Leavell claimed that it was entitled to an equitable adjustment under the suspension of work clause because the Government's failure to provide sufficient funds forced a shutdown of Leavell's operations from January 10 to until about July 1, 1969. The Government argued that Leavell had elected to suspend operations during that period, as it had the right to do under the funds available clause, when appropriated funds available for work under the contract were exhausted, and relied upon that part of the clause providing that the

Government would not be liable for damages on account of delay in payments due to lack of available funds. The Government further contended that Leavell on its own volition accelerated its rate of progress, and in so doing took the risk that additional funds might not be provided to meet such accelerated progress schedule. Leavell responds that while the funds available clause (SP–19) may preclude any claim for common law damages for breach of contract, it does not bar an equitable adjustment under the suspension of work clause (GP–42), when work is suspended for an unreasonable length of time due to lack of funds.

The Board decided the case adversely to Leavell, stating in part:

> It is the opinion of this Board that the Corps of Engineers acted reasonably in the allocation of funds available to it during the life of this contract and did not unfairly burden this contract for the benefit of others. Priorities were established on the basis of rational decisions and funds were allocated accordingly.
>
> * * * * *
>
> For this contract the Corps of Engineers was able to provide approximately $9.2 million during the first 1½ years of work on a contract which was to run 3 years and cost approximately $15 million. Appellant used all of the $9.2 million in completing approximately 58% of the work during the first 1½ years. Another $715,000 was provided at the end of the second year for a total of approximately $10.0 million, which is about two-thirds of the total contract price.
>
> * * * * *
>
> Despite * * * knowledge of funding difficulties and in contrast to the actions of the Corps of Engineers, appellant did nothing to alleviate the situation created by the shortage of funds. On the contrary, it compounded that situation by adhering to a schedule which would produce optimum profits—one which contemplated pushing the job hard during the first two years and substantial completion of all work approximately six months in advance of the contract completion date. This was a conscious business decision made by appellant after careful consideration of the risks involved and was prompted in part by appellant's experience on previous Corps of Engineers projects, funded as this one was, where the Corps of Engineers had always before

been able to provide all the funds necessary to meet appellant's requirements.

This time appellant made the wrong decision. The Corps of Engineers was unable to provide funds as fast as appellant could generate demands for funds. But it is our judgment that the flow of funds to this contract was not so small or so slow that the work could not have been accomplished at a reasonable pace and with only those delays in payment contemplated by SP–19 if appellant had been willing to cooperate and accept those delays. * * *

It was appellant's decision not to modify the pace of its work operations and not to accept delays in payment. We believe that this decision resulted in a conversion of the payment delays contemplated by SP–19 into a suspension of the work for which appellant now seeks compensation.

Appellant cannot be permitted to circumvent one of the most important and central provisions of the agreement which it executed with the government and avoid the consequences of the suspension which it could have prevented and should have prevented in view of SP–19 and its knowledge of the availability of funds.

Leavell attacks the Board's decision claiming that it is not entitled to finality because it fails to comply with the standards of the Wunderlich Act (41 U.S.C. §§ 321–22) or, in the alternative, that the defendant has breached the contract as a matter of law. The defendant responds that the Board's findings and decision are fully supported by substantial evidence and are correct as a matter of law. It adds, however, in any event, Leavell is precluded from any recovery in this law suit because of the express provisions of the funds available clause in the contract.

It is fairly apparent from the last two paragraphs of the Board's decision, quoted above, that the gravamen of the decision is the Board's finding that Leavell's accelerated pace of operations contributed materially to the necessity for the work suspension during the first six months of 1969. Accordingly, although not specifically articulated, the inference is clear that, in the Board's view, the admitted suspension of the work here came about, at least in part, through Leavell's fault or negligence in maintaining a fast pace. Hence, by its very terms, relief under the suspension of work

clause would be unavailable. Despite numerous references by the Board to the funds available clause (SP–19) in this contract, the decision does not deal with the specific impact of that clause, nor does it attempt to harmonize a possible inconsistency between SP–19 and the suspension of work clause (GP–42) also included in this contract.

This approach to the problem may well account for the entry into the case, as amicus curiae, of The Associated General Contractors of America (AGC). The amicus brief of this well-known national association examines in depth the problem which arises upon the failure of the Government adequately to fund a Government contractor's work according to an approved progress schedule where the contract contains both a funds available clause and a suspension of work clause. AGC takes the position that, irrespective of whether Congress or the contracting agency bears responsibility for inadequate funding, the history and development of the funds available clause show that it was never intended to place the entire risk of insufficient funding on the contractor, especially where it is coupled with the more recent suspension of work clause. To the defendant, however, the amicus brief is simply "a meritless exercise in semantics," a refusal, as it were, to believe that SP–19 really means what it says.

It is obvious from its opinion that the Board decided not to reach the broad question of whether SP–19 overrides the suspension of work clause, GP–42, in cases of funding shortages. Instead, the Board adopted the lenitive solution of finding that Leavell, because of its rapid work pace, had only itself to blame for its troubles.[2] Thus, Leavell's demonstrated efficiency in striving to keep abreast of its approved progress schedule became in the end its *bete noire*. Surely a Government contractor deserves more of an answer than that.

A logical and convenient starting place for analysis of this contract interpretation problem is a brief review of the origin and evolution of SP–19 and its predecessor clauses. The so-called "continuing contract" such as the one involved

[2] Indeed, the amicus assumes that "the Board's decision would have been favorable to the contractor in the absence of a finding of acceleration." Amicus Brief p. 47. In reply, the Government merely observes that this "tongue-in-check [sic] remark is patently without foundation or merit."

here was first authorized by § 10 of the River and Harbor Act of September 22, 1922, c. 427, 42 Stat. 1043, 33 U.S.C. § 621, providing:

> Any public work on canals, rivers, and harbors adopted by Congress may be prosecuted by direct appropriations, by continuing contracts, or by both direct appropriations and continuing contracts.

Prior to the enactment of Section 10, it had been the practice of the Corps of Engineers to seek a Congressional appropriation for the entire cost of a given project at the outset thereof. The Corps apparently felt obliged to follow such a practice because of the so-called "anti-deficiency" statutes which, *inter alia*, proscribe the involvement of the Government in any contract for future payment of money in excess of appropriations for a given fiscal year.[3] This practice resulted, of course, in the Corps holding large unexpended balances during the initial stages of large multi-year projects thus leading to subsequent difficulties in obtaining other appropriations while the Corps had unused, even though committed, funds. In the interest of economy and efficiency, the Corps requested from Congress the authority to enter into "continuing contracts" whereby Congress would initially authorize a project and each year thereafter appropriate enough money to pay for the work planned for that year.[4] As noted above, Congress was agreeable to this request.

Immediately following the enactment of Sec. 10, the Corps asked the Comptroller General whether it could lawfully enter into a contract pursuant to Sec. 10 for a total cost of approximately $1 million when there was a current appropriation of only $300,000. The Comptroller's decision mentioned the general limitations of the "anti-deficiency" statutes and referred to previous decisions of the Comptroller of the Treasury holding that those statutes did not preclude entering into a contract for full completion of a project provided payment was limited to the appropriated amount and any payment above that was conditional upon future appropriations. See, 13 Comp. Dec. 478; 14 Comp. Dec. 755.

[3] See R.S. 3679, 16 Stat. 251, as amended (31 U.S.C. § 665) and R.S. 3733, 15 Stat. 177 (41 U.S.C. § 12).

[4] See Hearings on H.R. 10766, House Committee on Rivers and Harbors, 67th Cong., 2d Sess., pp. 93–94.

The proposed specifications submitted by the Corps included such a liability limiting clause, as follows:

> The amount now on hand available for payment for contractors' estimates for the execution of the work to be done as defined in paragraph 19 is about $275,000. It is expected that Congress in accordance with the provisions of the act quoted in this paragraph (act of September 22, 1922) will make additional appropriations before available funds are exhausted, but as to this it must be distinctly understood and agreed that the United States is in no case to be made liable for damages in connection with this contract on account of delay in payment due to lack of funds. Should it become apparent that the available funds will be exhausted before the completion of the contract, the contracting officer will give 30 days' written notice to the contractor that work may be suspended; but if the contractor so elects he may continue work under the conditions and restrictions of the specifications, after the time set by such notice, so long as there are funds for inspection and superintendence, with the understanding, however, that no payment will be made for such work until additional funds shall have been provided in sufficient amount.

With the inclusion of this clause, the Comptroller General determined there was authority to enter into the contract, and stated at 2 Comp. Gen. 477, 479:

> If this paragraph be made a part of the contract and it be specifically provided that the Government is not bound for the payment of any sum in excess of that now available from the allotment by the Secretary of War nor liable in any manner for the failure of Congress from time to time to appropriate funds for so much of the work done in excess of available funds, or to appropriate funds to continue or complete the work, there would appear to be authority for entering into such contract under the authority of the act of September 22, 1922.[5]

[5] The amicus argues that if a liability-limiting clause had to be included, then Sec. 10 was superfluous since the Comptroller of the Treasury had already determined the anti-deficiency statutes did not preclude entering into contracts for more than the appropriated amount so long as *payment* for more than that amount was conditional on future appropriations. Therefore, it is said that the precursor of SP–19 was "unnecessary" and "mistakenly required in continuing contracts" (AGC Brief, p. 25). However valid these observations, their relevancy is doubtful since no one appears to dispute the legality and validity of SP–19 as such, and whether superfluous or not, the fact remains that it is specifically included in the present contract.

For the next 35 years, the exculpatory provisions of the funds available clause remained substantially the same as in the clause quoted above from the Comptroller General's decision. Then, in 1957 and 1958 several major revisions of the clause were made,[6] and (including some later paragraph reorganization) the resulting clause became virtually identical to SP–19 reproduced in Appendix A, *infra*.

The substantive changes to the extent relevant here included the following:

(a) Work in excess of funds available would be "continued with funds hereafter appropriated *and allotted for this work*." (Emphasis added; see SP–19(a).)

(b) Provisions relating to the rate of work progress were included and added a further liability disclaimer to the effect that the amount of funds presently available would be the maximum amount available for the current fiscal year and that the Government would in no case be liable for payments in excess of that amount. See SP–19(d).

(c) A provision similar to SP–19(i) was added providing, *inter alia*, that a progress schedule contemplating progress at a greater rate than could be paid for with currently available funds would be approved "only under the condition that such approval will in no way obligate the Government to make additional funds available for the work." [7]

Before proceeding to an analysis of relevant case material, and particularly because of a major contention by Leavell that in the allocation of overall funds appropriated for the

[6] See, for example, EM 1180–1–16, particularly Change 6 on March 17, 1958, and Change 8 on September 2, 1958.

[7] Subsequent to the arising of the dispute in this case, the progress schedule provisions were further changed to eliminate the contractor's option of submitting for conditional approval an accelerated progress schedule, as occurred here, ER 1180–1–1, Change 14, March 24, 1972. It appears fairly obvious that the change was prompted by the Corps' concern to avoid in the future any semblance of Government approval of progress schedules conflicting with the amount of funds available for payments. The following explanation for the 1972 change appears in the Engineer Contract Instructions:

"Revised coverage in subparagraphs (d) and (i) and a new subparagraph (j) eliminate the contractor's option of submitting for conditional approval a progress schedule that would require funds during the current fiscal year in excess of the amount stated to be currently available. The clause as changed provides that the portion of a progress schedule covering the time for which funds have been made available must be consistent with the amount of such funds, and that the contractor, if he intends to work at a faster rate, must submit an additional progress schedule *for information only.*" (ECI 7–671.4) [Emphasis supplied.]

Ouachita and Black Rivers project, the Corps acted unreasonably and discriminatorily, a brief summary of the appropriations processes as practiced within Congress and the Corps will be helpful.[8]

A full year before a given fiscal year begins, the Corps' districts prepare their individual budgets based on contractual needs within their respective districts. These are reviewed and frequently adjusted by the Office of Chief Engineer (OCE) and then forwarded for possible further adjustments to the Office of Management and Budget (OMB). They are then sent to subcommittees of the appropriation committees of both Houses of Congress where hearings are conducted. Differences between the two Houses are resolved in conference prior to final passage of the appropriation bill.

In civil works programs, Congress appropriates funds by project only and not by contract. The Conference Report contains an overall deduction for "slippage and shortage" which is a form of underfinancing designed to take into account expected slippage and savings on contracts. While OCE makes a pro-rata deduction for such underfinancing in its allocation to each district, it is only at the district level that the actual allotment for individual contracts is made. Therefore, the district has discretion as to how it distributes the available funds among the various contracts within a particular project.

With respect to transfer authority, OCE can transfer to a particular project up to 15 percent of the appropriated funds available for that project at the beginning of a fiscal year.[9] The district engineer has unlimited authority to transfer funds between contracts within a single project, and he has a limited authority to transfer funds between projects up to 10 percent of the original work allowance for that fiscal year, or $100,000, whichever is less.

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[8] As stated above, the Board concluded that the Corps acted reasonably in its allocation of available funds and did not unfairly burden Leavell's contract for the benefit of others. The amicus regards it as immaterial whether the responsibility for inadequate funding rests with Congress or with the Corps. (AGC Brief p. 4, 28.) *Cf., S. A. Healy Co.*, IBCA, 74–2 BCA ¶ 10,708, discussed below.

[9] This authority relates only to funds for a project and not to any particular contract since OCE does not allocate to the contract level.

For FY 1969, the Revenue and Expenditure Control Act of 1968, *inter alia*, placed a ceiling on spending by the Executive Branch. The effect was to reduce the actual expenditure of already appropriated funds by $6 billion in that fiscal year. Faced with the rather novel uncertainties inherent in that Congressional action, OCE decided early in FY 1969 not to utilize its transfer authority for fear of overcommitment of available funds. Towards the end of that fiscal year, however, the financial situation had clarified to the point where the Corps on May 27, 1969, could advise Leavell that the Government had approximately $800,000 available as of July 1, 1969, to pay for materials and equipment delivered to the site prior thereto.[10]

From tabulations contained in the Board record it is clear (and apparently undisputed) that from the date of the contract award through November 29, 1968, when Leavell was notified of the exhaustion of funds, the total amount allocated to this contract exceeded the total amount included for the contract in the budget request by over $427,000. Therefore, of course, Leavell can only complain that OCE should have exercised its discretionary transfer authority. There is, however, substantial evidence that the failure of OCE to exercise its transfer authority in the present circumstances was reasonable conduct necessitated by the expenditure ceiling imposed by the Revenue and Expenditure Control Act. The question remains as to whether the Corps acted reasonably in its allocation of funds and whether it unfairly burdened Leavell's contract for the benefit of others. As this court said in *Winston Bros. Co.* v. *United States*, 131 Ct. Cl. 245, 130 F. Supp. 374 (1955):

> * * * We think the provision [i.e. the funds available clause] at least means that where the agency authorized to spend the appropriation allocates the funds on a *rational and non-discriminatory basis* and they prove insufficient, the Government is not liable for harm resulting from the shortage. [Emphasis supplied.] (*Id.* at 254, 130 F. Supp. at 380.)

The question then is whether or not funding of Leavell's contract as compared to other contracts under the project

[10] Meanwhile, as stated above, Leavell's work on the contract had been suspended from January 10, 1969, to June 16, 1969.

was irrationally or discriminatorily done. The two critical years relative to this dispute concerning the funding of Leavell's contract through date of exhaustion of funds are fiscal years 1968 and 1969. From figures in the Board's record, an analysis of the budget requests and allocations for these years is as follows:

Budget Request

Fiscal year	*Project*	*Leavell's Contract*
1968	$8, 700, 000	$2, 900, 000
1969	8, 300, 000	5, 656, 000
	$17, 000, 000	$8, 556, 000

Conference Report

Fiscal year	*Project*	*Leavell's Contract*
1968	$8, 700, 000	Not applicable [a]
1969	8, 051, 000	Not applicable
	$16, 751, 000	

Actual Obligations

Fiscal year	*Project*	*Leavell's Contract*
1968	$9, 314, 000	$4, 658, 300
1969	6, 982, 000	[b] 4, 500, 000
Totals	$16, 296, 000	$9, 158, 300

[a] Conference Reports only allocate by projects and not individual contracts.
[b] As of the date of exhaustion of funds.

The significance of the above is that, although the Conference Report allowances for the Ouachita and Black Rivers project were $249,000 less than the budget request for the project for FY 1968 and 1969, funds obligated against plaintiff's contract during the period were $602,300 more than the budget request for this contract. It is also noted the actual total obligations to the entire project were $455,000 less than the total of the Conference Report allowances for those years. These facts demonstrate that Leavell was not treated unfairly with respect to allocations within this project, and the Board's finding to that effect is fully supported by the evidence before it.

This is not the end of the matter, however. There remains the major problem of contract interpretation stemming from the apparent conflict between the funds available clause and

the suspension of work clause, both mandatory provisions in a contract such as the present.[11] In such a situation, the starting point must be "the established canon that contract provisions should not be construed as conflicting unless no other reasonable interpretation is possible." *Thompson Ramo Wooldridge, Inc.* v. *United States*, 175 Ct. Cl. 527, 536, 361 F. 2d 222, 228 (1966).

For the moment, let it be assumed that the Leavell contract did *not* contain the exculpatory language of SP–19 reading:

> It is understood and agreed that the Government is in no case liable *for damages* in connection with this contract on account of *delay in payments* to the Contractor due to lack of available funds. [Emphasis supplied.]

Under such a hypothetical assumption, it would seem clear enough that, despite the Board's rather vague indication to the contrary, Leavell would have been entitled to an *equitable adjustment* under the suspension of work clause (GP–42) for the period of work suspension involved. To hold otherwise simply on the ground that the contractor's performance was sufficiently efficient as to be ahead of schedule would seem to be an unwarranted emasculation of GS–42.

The fact remains, of course, that the exculpatory language above quoted was very much present in the Leavell contract, and consideration must therefore be given to the question of whether such language was intended by the contracting parties to be a means of eliminating any possibility of equitable relief under GP–42. To the Government the answer is simple, indeed; wherever delay is the result of funding shortages, the disclaimer of any liability to the contractor is crystal clear and should put an end to the matter. The contractor, on the other hand, reads the exculpatory language as disclaiming liability only where the unavailability of funds causing the work suspension amounts to a breach of contract and therefore does not preclude an equitable adjustment under the suspension of work clause.

The only case in which this court has considered the effect of a funds available type clause is a Congressional reference

[11] It is, of course, hornbook law in this area that the court is free to decide such a question for itself regardless of the decision of the Board. See, for example, *Paccon, Inc.* v. *United States*, 185 Ct. Cl. 24, 399 F. 2d 162 (1968).

case. *Winston Bros. Co.* v. *United States*, *supra*. There, in a Bureau of Reclamation irrigation project, funding difficulties arose which faced the Bureau with the problem of how to allocate the available funds among a variety of competing needs. To an extent the Bureau allocated in accordance with its understanding of Congressional wishes expressed in the conference committee report and gave preference to completion of certain power facilities. Accordingly, funds for the plaintiffs' contracts were temporarily curtailed, and they in turn were forced to curtail their operations with resulting standby, overhead, and related expenses. Their contracts contained the following unambiguous disclaimer of liability for the consequences of insufficient funding:

> *Specifications, par. 11.*
>
> *Failure of Congress to appropriate funds.* If the operations of this contract extend beyond the current fiscal year, it is understood that the contract is made contingent upon Congress making the necessary appropriation for expenditures thereunder after such current year has expired. In case such appropriation as may be necessary to carry out this contract is not made, the contractor hereby releases the Government from all liability due to the failure of Congress to make such appropriation. 131 Ct. Cl. at 247, 130 F. Supp. at 376.

In determining that this provision foreclosed any judicially enforceable claim, the court said:

> Assuming, then, that the Bureau's allotment between power and irrigation was lawful, we reach the Government's defense that it was not a breach of contract for the Government to fail to make funds available to pay for work for which it had contracted. The Government bases this defense upon the provision of the contracts which we have quoted earlier in this opinion. That provision, Paragraph 11 of the Specifications, said that if the operations of the contract extended beyond the current fiscal year, the Government would not be liable for the consequences of the failure of Congress to appropriate funds to carry out the contract.
>
> The plaintiffs urge that this provision is no defense. They point to the language "In case such appropriation as may be necessary to carry out this contract is not made * * *" and say that, taking each plaintiff's contract by itself, there was plenty of money appropriated

> to carry it out, even after giving the preference to the power features of the project. We think that this is a too literal reading of Paragraph 11. It would make the provision practically inapplicable except in cases where specific parts of appropriations were earmarked for particular contracts. *We think the provision at least means that where the agency authorized to spend the appropriation allocates the funds on a rational and non-discriminatory basis and they prove insufficient, the Government is not liable for harm resulting from the shortage.* 131 Ct. Cl. at 253–4, 130 F. Supp. at 380, [emphasis added]

It should be noted that in *Winston* the claims were asserted as tantamount to a breach of contract rather than for an equitable adjustment under a suspension of work clause, as here. There is nothing in the case to indicate whether the *Winston* contracts contained such a clause, and it may be assumed they did not. The case is relevant here, therefore, only insofar as it establishes a standard of conduct for agencies in their allocation and allotment of available funds, and it has already been concluded above that the Corps' allocation in the present case was neither irrational nor discriminatory.

Except for the present case, the question of interaction between the funds available and suspension of work clauses seems to have arisen only before the Department of interior Board of Contract Appeals. *Granite Construction Co.*, 72–2 BCA ¶ 9762, and *S. A. Healy Co.*, 74–2 BCA ¶ 10,708. In *Granite*, the contractor sought to recover its costs incurred during a constructive suspension of work when funds became unavailable due to a Presidential impoundment action. As stated by the Board:

> The issue before us is the applicability of the standard Suspension of Work clause where completion at a date earlier than provided for in the contract was authorized by the Government but was delayed as a result of funding problems. [p. 45,583]

The ICBA decided the issue adversely to the contractor but on grounds that show the case to be entirely distinguishable from the present one. In the first place, the Board treated the executive impoundment of funds as a "sovereign act" clearly not attributable to the contracting officer under the suspension of work clause. In addition, while the two clauses

under discussion were quite similar in both *Granite* and the present case, there are some significant differences. In *Granite*, the suspension of work clause specifically excepted from its reach any "equitable adjustment * * * excluded under any other provision of this contract," an exception not present in the instant case. Also, the funds available clause in *Granite* raised the following "red flag" to every prospective bidder:

> The contractor is also cautioned that the prosecution of the work at a rate that will exhaust the funds reserved before the end of the fiscal year will be *at his own risk.* [Emphasis supplied.]

No such risk allocation language is present in the funds available clause of the Leavell contract. Because of these several distinctions, the Government's reliance on *Granite* as a significant precedent seems misplaced.

In the *Healy* case (n. 8), the same funds available clause was present as in *Granite* but the funding shortage there resulted from the agency's own administrative decisions. Healy's proposed construction schedule, which contemplated accomplishing most of the work at the beginning of the contract, had been approved "without comment". The budget requests submitted by the agency, however, reflected light funding in the beginning and heavy funding toward the end of the contract period. Healy argued that the agency's action was a constructive change of the schedule and sought an equitable adjustment under the *changes clause.*

The Government's motion to dismiss on the ground that Healy's sole remedy was for breach of contract was denied with direction for a further hearing to determine what action, if any, the contractor had taken to scale down its operations to conform to the funds available.

From the foregoing, it is clear that the precise relationship of the funds available clause (SP–19) to the suspension of work clause (GP–42), and the risks allocated thereby, remain undefined. In considering that relationship, it is important to keep constantly in mind the basic principles developed by this court over the years in harmonizing separate provisions of a Government contract. Very recently, Judge Davis has given us an admirable and concise summary of

those principles in his opinion for the court in *Contra Costa County Flood Control and Water Conservation District* v. *United States*, 206 Ct. Cl. 413, 421, 512 F. 2d 1094, 1098, decided March 19, 1975. There, he observes:

> *Bilateral contracts should be applied, if fairly possible, so as not to put one side at the mere will or mercy of the other. Padbloc Company* v. *United States*, 161 Ct. Cl. 369, 376–77 (1963); *Deloro Smelting & Refining Co.* v. *United States*, 161 Ct. Cl. 489, 496–97, 317 F. 2d 382, 387 (1963).
>
> This coordination of the various terms of the agreement seem to us distinctly preferable, even without the *contra proferentem* rule, to the Government's understanding that it had all (or nearly all) the rights and practically no responsibilities. But if the contract be deemed more ambiguous and less clear, then the usual canon should be invoked. *Sturm* v. *United States*, 190 Ct. Cl. 691, 697, 421 F. 2d 723, 727 (1970). *The Government presented plaintiff with the form of the agreement, and the plaintiff's interpretation was at least reasonable, if not in fact the better one.* [Emphasis supplied.]

To Leavell and the amicus, AGC, it is important to recall that in the years preceding the adoption of a funds available clause in the early 1920s, a failure on the part of Congress for any reason to fund an existing Government contract was held to be a breach of contract. *See*, for example, *Ferris* v. *United States*, 27 Ct. Cl. 542 (1892). In such event, the contractor presumably would have been entitled, on the date of fund exhaustion, to discontinue performance and pursue its breach of contract remedies, including future profits. But SP–19 (and its predecessor clause) changed all that by saying in effect that such an exhaustion of funds was not a breach and that the contractor must either finance the work himself, or in the alternative, suspend activities but stand by and remain available to recommence work when, and if, funding was resumed. Thus, says Leavell, it is reasonable to interpret SP–19's liability disclaimer as applicable *only to damages for breach of contract.*

When, many years later, the suspension of work clause came into vogue with its equitable adjustment concept, it was reasonable to assume, say Leavell and AGC, that the exculpatory language of SP–19, unchanged since 1923, con-

tinued as before to apply *only* to damages for breach and was never designed or intended to preclude an equitable adjustment under the much later suspension of work clause.[12] Were this not to be so, the argument goes, it would have been a simple thing indeed to have added to SP–19's exculpatory language a specific prohibition against equitable relief under GP–42.[13]

There is little doubt of the historical validity of the distinction drawn by Leavell and the AGC between damages for breach of contract as precluded by SP–19 and an equitable adjustment for unreasonable delays contemplated by the suspension of work clause. A number of decisions by this court demonstrate the difference. For example, in *John A. Johnson & Sons* v. *United States*, 180 Ct. Cl. 969 (1967) the court concluded:

> *But the plaintiff's right to a price adjustment under the suspension of work clause does not depend on a breach of the contract by the defendant.* The issue is whether the defendant, for its own advantage and convenience in administering the project, has taken action which delayed the plaintiff's access to its worksites for an unreasonable length of time and thereby caused the plaintiff additional expense not due to the plaintiff's fault or negligence. *If it has, the suspension of work clause directs that the contracting officer shall make an equitable adjustment in the contract price.* 180 Ct. Cl. at 990 [Emphasis supplied.]

In the same vein are the cases of *T. C. Bateson Constr. Co.* v. *United States*, 162 Ct. Cl. 145, 319 F. 2d 135 (1963); *Urban Plumbing & Heating Co.* v. *United States*, 187 Ct. Cl. 15, 408 F. 2d 382 (1969), *cert. denied*, 398 U.S. 958 (1970); and *Merritt-Chapman & Scott Corp.* v. *United States*, 192 Ct. Cl. 848, 429 F. 2d 431 (1970). In *Merritt-Chapman*, the court stated:

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[12] The clause appears to have originated with the Corps of Engineers during World War II and, at least in part, was designed to ameliorate what many considered to be a harsh result in *United States* v. *Rice*, 317 U.S. 61 (1942). *See* Easterwood, "Pay For Delay," 1 Govt. Contracts Rev. 5 (Jan. 1957) and Clarke, "Government-Caused Delays in the Performance of Federal Contracts," 22 Mil. L. Rev. 1, 28 (Oct. 1963).

[13] This principle was once described by the late Judge Jerome Frank as the familiar "easy-to-say-so-if-that-is-what-was-meant" rule. *Commissioner* v. *Beck's Estate*, 129 F. 2d 243, 245 (2d Cir., 1942).

Opinion of Trial Judge

* * * There is no doubt, as the trial commissioner holds, that the work was in fact suspended and delayed for the Government's convenience, and also that there was a significant change in design. It is immaterial, in this instance, whether or not the suspension and delay was due, in whole or in part, to the Government's fault. There are occasions for the Suspension of Work clause to operate when the Government is at fault, as we recently noted (See *Chaney & James Constr. Co.* v. *United States* 190 Ct. Cl. 699, 705–08, 421 F. 2d 728, 731–33 (1970)), but the clause can likewise be effective, as we have also held, when there is a suspension not due to the Government's fault, dereliction or responsibility. See *T. C. Bateson Constr. Co.* v. *United States*, 162 Ct. Cl. 145, 319 F. 2d 135 (1963); *John A. Johnson & Sons* v. *United States*, 180 Ct. Cl. 969 (1967). An instance of the latter category is a suspension and delay which lasts so long (regardless of the absence of government fault) that the contractor cannot reasonably be expected to bear the risk and costs of the disruption and delay. That is one type of suspension and delay "for an unreasonable length of time causing additional expense", within the meaning of the clause. Depending on the circumstances, a delay due to a non-fault suspension by the Government can obviously be so protracted that it would be unreasonable to expect the contractor to shoulder the added expense himself. We think that in its terms and its purpose the Suspension of Work clause covers that situation, among others. 192 Ct. Cl. at 852, 429 F. 2d at 432.

Under the rationale of these cases, it is fair to conclude that an SP–19 suspension is one for the convenience of the Government within the intendment of the suspension of work clause. Such a suspension is clearly designed to keep the contractor available for a period of time after exhaustion of funds while the contracting agency awaits either additional funding from the Congress or from discretionary allocations of appropriated funds within its own organization. In these situations, when funding again becomes available, the Government is spared the expense, delay, and inconvenience incident to reletting the contract. Surely the Government should expect to pay for this extra contract right by reimbursing the contractor for his additional costs incurred while in stand-by status unless through clear and specific language that risk is allocated to the contractor alone.

Conclusion of Law

From all that has been said, I am constrained to conclude that, in the words of *Contra Costa*, *supra*, "the plaintiff's interpretation was at least reasonable, if not in fact the better one." Clearly, a contractor operating under a contract containing both SP–19 and GP–42 must realize he bears the risk of suspension for lack of funds even though his work progress is current. In such event, he knows he has no right to profit on any suspension costs, nor does he have any right to damages for breach of contract. Further, he must realize that if he is able and decides to finance the work himself, there is no guarantee of recovery even of the interest paid on money borrowed for that purpose. By a fair reading of the two clauses, however, he would not be alerted to the Government's present contention that he bears the *additional* risk of enduring a suspension of work under an approved schedule without any reimbursement for his stand-by costs.

Since it is fair to ask that when prospective Government contractors are evaluating their risks for contingency bidding purposes, they should be precisely informed as to where all contractual risks are allocated, it is my opinion that SP–19 and GP–42 should be harmonized so as not to defeat both reasonable and legitimate expectations of the contractor. Particularly is this true when it is considered that, assuming the Government's adversarial position in this lawsuit to be truly representative of the contracting agency's original intention, SP–19 could have easily been worded so as specifically to preclude any equitable adjustment under GP–42 for a suspension delay attributable to a funding shortage. I consider it of controlling significance that this was never done.

Accordingly, the decision of the Corps of Engineers Board must be reversed to the extent it holds, as a matter of law, that Leavell is not entitled to an equitable adjustment under the suspension of work clause for its delay costs between January 10, 1969 and June 16, 1969.

CONCLUSION OF LAW

Plaintiff's motion for summary judgment is granted, defendant's cross-motion is denied, and the case is remanded to the Corps of Engineers Board of contract Appeals. Further proceedings are stayed pursuant to Rule 149 for a pe-

riod of six months to afford the parties an opportunity to obtain an administrative resolution by the Board of the equitable adjustment in contract price to which plaintiff is entitled. The attorney of record for plaintiff is designated to advise the court, by letter to the trial judge (with copy to opposing counsel), of the status of proceedings on remand, such advice to be given at intervals of 90 days, or less, from the date hereof. Attention of counsel and the Board is also directed to Rule 150.

APPENDIX

SP-19. *Funds Available for Payments.*

(a) Such work as may be done under this contract in excess of the amount for which funds are available for payment as herein set forth, will be continued with funds hereafter appropriated and allotted for this work.

(b) From funds heretofore appropriated, the sum of $75,000.00 is available for payments to the Contractor for work performed under this contract, including the retained percentage.

(c) If at any time it becomes apparent to the Contracting Officer that the balance of this allocation is in excess of the amount required to meet all payments due and to become due the Contractor because of work performed and to be performed pursuant to his approved progress schedule, the right is reserved after due notice to the Contractor to reduce said allocation by the amount of such excess.

(d) If the rate of progress of the work is such that it becomes apparent to the Contracting Officer that the balance of this allocation and any allocation for this and any subsequent fiscal years during the period of this contract is less than that required to meet all payments due and to become due the Contractor because of work performed or to be performed under this contract, the Contracting Officer may provide additional funds for such payments if there be funds available for such purpose. The Contractor will be notified in writing of any additional funds so made available. However, it is distinctly understood and agreed that the amount of funds stated in (b) above is the maximum amount the Government insures will be available during the current fiscal year and the Government is in no case liable for pay-

ments to the Contractor beyond this amount prior to having notified the Contractor in writing of any additional funds that can be made available. Accordingly, no progress schedule will be approved (see paragraph (a) of the clause of the contract entitled "Progress Charts and Requirements for Overtime Work") which contemplates progress requiring funds in excess of the amounts stated to be available in (b) above for the current fiscal year and no progress schedule will be approved for any ensuing fiscal year which contemplates progress requiring funds in excess of the amount allocated by the Contracting Officer from funds subsequently made available, except as set forth and subject to the conditions in subparagraph (i) below.

(e) It is expected that, during the subsequent fiscal years over the period of this contract, Congress will make additional appropriations for expenditure on work under this contract. The Contracting Officer will notify the Contractor of any additional allocation of funds to this contract when such funds become available. It is understood and agreed that the Government is in no case liable for damages in connection with this contract on account of delay in payments to the Contractor due to lack of available funds. Should it become apparent to the Contracting Officer that the available funds will be exhausted before additional funds can be made available, the Contracting Officer will give at least 30 days written notice to the Contractor that the work may be suspended. If the Contractor so elects, after receipt of such notice, he may continue work under the conditions and restrictions under the specifications, so long as there are funds for inspection and superintendence, with the understanding, however, that no payment will be made for such work unless additional funds shall become available in sufficient amount. When funds again become available, the Contractor will be notified accordingly. Should work be thus suspended, additional time for completion will be allowed equal to the period during which work is necessarily so suspended, as determined by the dates specified in the abovementioned notices.

(f) So long as funds are available, payments will be made monthly in accordance with article of the contract

entitled "Payments to Contractors." The unit prices or lump sum price stated in the contract will be used in determining the amount to be paid for work performed by the Contractor.

(g) The procedure above described will be repeated as often as may be necessary on account of the exhaustion of available funds and the necessity of awaiting the appropriation of additional funds by Congress.

(h) Should Congress fail to provide additional funds the contract may be terminated and considered to be completed, at the option of the Contractor, without prejudice to him or liability to the Government, at any time subsequent to 30 days after payments are discontinued, or at any time subsequent to 30 days after the passage of the Act which would have but did not carry an appropriation for continuing the work or after the adjournment of the Congress which failed to make the necessary appropriations. However, if the funds cited in the contract are enough to extend the work beyond the end of the fiscal year and no new funds are allocated to this contract for the ensuing fiscal year, the Contractor must first exhaust all the cited funds and thereafter he may, at his option, exercise the rights provided in this paragraph any time after payments are discontinued.

(i) The progress chart prepared in accordance with paragraph (a) of the clause of the contract entitled "Progress Charts and Requirements for Overtime Work" will be consistent with the amount of funds stated in subparagraph (b) above as being currently available for the period of time from the date of contract award to the end of the fiscal year in which the contract was awarded, or at the option of the Contractor, the chart may be prepared on the basis of accomplishment of work at a greater rate of progress for the period of time applicable to currently available funds. Any chart initially submitted for approval which contemplates progress at a greater rate than can be paid for with currently available funds will be approved only under the condition that such approval will in no way obligate the Government to make additional funds available for the work. That part of the chart which covers the work for which funds are not currently available will be prepared on the basis of a schedule considered to be practicable by the Contractor for the accom-

plishment of the work at such rate of progress as he may desire for completion within the terms of the contract. The progress chart will be revised each time the Contractor is notified that additional funds are made available. Each revision will conform with the criteria stated above. With reference to the responsibilities for future funding of the work in accordance with the progress chart, attention is called to the preceding subparagraphs wherein the responsibilities of the Government are set forth for the furnishing of funds for the work. The approval of that part of the schedule covering work for which funds are not currently available will in no way obligate the Government to provide funds to accomplish work at the rate of progress indicated in the schedule.

GP–42. *Price Adjustment for Suspension, Delays, or Interruption of Work (Nov. 1961)*

(a) The Contracting Officer may order the Contractor in writing to suspend all or any part of the work for such period of time as he may determine to be appropriate for the convenience of the Government.

(b) If, without the fault or negligence of the Contractor, the performance of all or any part of the work is for an unreasonable period of time, suspended, delayed, or interrupted by an act of the Contracting Officer in the administration of the contract, or by his failure to act within the time specified in the contract (or if no time is specified within a reasonable time), an adjustment shall be made by the Contracting Officer for any increase in the cost of performance of the contract (excluding profit) necessarily caused by the unreasonable period of such suspension, delay, or interruption, and the contract shall be modified in writing accordingly. No adjustment shall be made to the extent that performance by the Contractor would have been prevented by other causes even if the work had not been so suspended, delayed, or interrupted. No claim under this clause shall be allowed (i) for any costs incurred more than 20 days before the Contractor shall have notified the Contracting Officer in writing of the act or failure to act involved (but this requirement shall not apply where a suspension order has been issued), and (ii) unless the claim in an amount stated, is

Syllabus

asserted in writing as soon as practicable after the termination of such suspension, delay, or interruption but not later than the date of final payment under the contract. Any dispute concerning a question of fact arising under this clause shall be subject to the dispute clause. (ASPR 7–602.46).

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529 F. 2d 1312

ROYAL INDEMNITY COMPANY v. THE UNITED STATES

[No. 161–67. Decided January 28, 1976]

ON THE PROOFS

Contracts; performance and payment bond surety; right to progress payments.—Plaintiff, payment and performance bond surety on a construction contract at Tullahoma, Tennessee, seeks to recover a sum representing the total of six progress payments made by defendant to the contractor prior to default termination of the contract, but after, *inter alia*, defendant was aware that certain subcontractors had not been paid, that construction was lagging, that the contractor had executed (among other documents) a joint control agreement in favor of the surety, which agreement the contractor subsequently "revoked." It is *held*, on balancing the Government's interests against the surety's, that the Government acted in good faith and primarily to promote the continuation and completion of the contract work, and that its action in making the payments to the contractor was a reasonable exercise of its discretion and not an arbitrary disregard of the surety's rights. Plaintiff is not entitled to recover and the petition is dismissed.

Contracts; subrogation; progress payments; surety on performance and payment bonds; rights and remedies of.

[1] Notwithstanding the interest of the Government in the timely and efficient completion of contract work, the Government has a clear duty, even during contract performance, to exercise its discretion responsibly, and to consider the interests of a surety in conjunction with other problems it may encounter in the administration of the contract. The Government must balance its own interests in proceeding with the contract against possible harm to the surety.

United States ⇐ 74(18)

Contracts; sureties; progress payments; arbitrary and capricious action; standard of proof.

[2] The standard of proof to be applied in a case where an arbitrary

Syllabus

and capricious disregard of the surety's interests and an abuse of discretion are charged is high. Where the Government is entitled to exercise its discretion, as in making progress payments to the faltering contractor, the surety has an unusually heavy burden of proof in showing that the determination made was arbitrary and capricious.

United States ⇐ 74(18)

Contracts; sureties; rights and remedies of; performance and payment bonds.

[3] The rights of a performance and payment bond surety under a Government contract as against the Government are not contractual in nature, but purely equitable, and are to be considered in the exercise of equitable discretion and with due regard to the legal and equitable rights of others.

United States ⇐ 74(18)

Contracts; payment; progress payments.

[4] It is common knowledge that Government contractors rely upon contract proceeds administered through progress payments to properly finance the contract. The Government cannot lightly withhold funds the contractor may need for this purpose.

United States ⇐ 73(16)

Contracts; payment; progress payments.

[5] Even where the Government knows that a contractor has serious financial difficulties, the Government does not become obligated either to withhold progress payments or to declare the contractor in default at the performance and payment bond surety's request, so long as the work progress is satisfactory to defendant and it has good reason to believe that the contract will be completed.

United States ⇐ 73(16)

Contracts; sureties; rights and remedies of; performance and payment bonds.

[6] Since it is superior policy, as far as the Government's interest in the cheapest and most rapid completion of the contract is concerned, to keep the original contractor going as long as possible even when he encounters financial difficulty, in deciding to continue contractor performance it was appropriate for the Government to consider the fact that the contractor's bid was far less than that of the next lowest bidder and that excess costs on readvertisement would, for that reason alone, be considerable.

United States ⇐ 74(18)

Richard H. Nicolaides, attorney of record, for plaintiff. *Leslie H. Wiesenfelder*, with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Opinion of Trial Judge

Before COWEN, *Chief Judge*, DAVIS and KASHIWA, *Judges*.

PER CURIAM: This case comes before the court on plaintiff's exceptions to the recommended decision, filed October 9, 1974, by Trial Judge Harry E. Wood, pursuant to Rule 134 (h), having been submitted on the briefs and oral argument of counsel. Upon consideration thereof, since the court agrees with the recommended decision, as hereinafter set forth*, it hereby affirms and adopts the same as the basis for its judgment in this case. Therefore, plaintiff is not entitled to recover and the petition is dismissed.

OPINION OF TRIAL JUDGE

WOOD, *Trial Judge:* In this action, again before the Trial Division for recommended decision on the merits,[1] plaintiff, payment and performance bond surety on a 1960 contract whereby Grenco Services, Inc. (hereinafter "Grenco") undertook to construct for defendant a "Gas Dynamics Facility Hyperballistics Range, including Range Auxiliary Building" at the Arnold Engineering Development Center, Tullahoma, Tennessee (hereinafter "the Tullahoma project contract" or "the Tullahoma project"), here seeks to recover from defendant some $254,000.

The gross amount in suit is the total of six progress payments made by defendant to Grenco prior to defendant's termination of Grenco's contract for default, but after subsequently described events which, according to plaintiff, required that defendant either forward progress payments to Grenco in care of plaintiff, "thus affording [plaintiff] joint control" over the funds, or at least withhold them from Grenco, "thereby assuring that the monies would be used first, to complete the project, and second, to pay the job obligations."[2]

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*Whereas the court adopts the trial judge's separate findings of fact, which are set forth in his recommended decision filed October 9, 1974, they are not printed herein since such facts as are necessary to the decision are contained in his opinion.

[1] See pp. 812–13, *infra*.

[2] Plaintiff now concedes that the gross amount claimed should be reduced by "any portion thereof that has been established as used in connection with the project."

I.

The Court's Order of Remand

In a recommended decision filed herein February 25, 1972, the trial judge reached neither plaintiff's elaborate chain of argument supporting its view that by making the six progress payments to Grenco defendant had breached an obligation to see that all of the monies so paid were devoted to the completion of the Tullahoma project, and that plaintiff was accordingly entitled to recover all such monies from defendant, nor the broadest of defendant's several contentions: that, absent a declaration by the contracting officer that Grenco was in default of its contract with defendant, defendant had neither a right nor a duty to withhold earned progress payments. It was held, rather, that even assuming "defendant could and should have given more consideration to 'the surety's interest in conjunction with other problems encountered in the administration of the contract',[3] the extent, if any, of resulting damage to plaintiff cannot be measured", and that plaintiff, having failed to establish that any measurable portion of its overall loss on the Tullahoma project was fairly attributable to defendant, was accordingly not entitled to recover.

Following oral argument on plaintiff's request for review of the said recommended decision,[4] the court, by order dated October 20, 1972, remanded the case to the trial judge with directions to determine, in essence, whether, in making the progress payments in question to Grenco, defendant acted in good faith and primarily to promote the continuation of the contract work, and whether, in light of all the facts and circumstances, defendant's actions were a reasonable exercise of its discretion or an arbitrary disregard of plaintiff's rights as surety and an abuse of such discretion.

Thereafter, the parties were afforded an opportunity to present further proof. Neither offered any further testimony, but documentary evidence on behalf of both was offered and received. Proof was closed in due course, and the issues

[3] *Argonaut Ins. Co. v. United States*, 193 Ct. Cl. 483, 495, 434 F. 2d 1362, 1368 (1970).

[4] The briefs and exceptions of the parties in connection with the request for review reflect that the contentions pressed before the trial judge were also urged upon the court.

framed by the order of remand are now ripe for decision. For reasons which follow, it is concluded that plaintiff is not entitled to recover.

II.

The Facts of the Case

A fairly detailed factual background is a prerequisite to clear perception and resolution of the difficult considerations here involved.

Grenco's bid of $1,329,444 on the Tullahoma project was $292,000 less than that of the next lowest bidder, and $621,000 less than defendant's own estimate of the cost of the work. At defendant's request, Grenco confirmed its bid, and, on July 22, 1960, it entered into the Tullahoma project contract with defendant at its bid price. Grenco then obtained from plaintiff a performance bond in the sum of $1,329,444, and a payment bond in the sum of $531,777.60, and commenced work on the project shortly after August 8, 1960, when it received notice to proceed. Work was to be completed within 540 days from commencement.

Grenco's application to plaintiff for both bonds was dated August 2, 1960, and was made on a Royal Indemnity Company form containing (among other things) an "Agreement of Indemnity" giving plaintiff a considerable number of rights vis-a-vis Grenco. There is no indication in the record that plaintiff then had any information about Grenco beyond that stated in the application form. Despite Grenco's failure to respond to many of the requests for information on the said form, there is also no indication that plaintiff sought any further information from or about Grenco prior to execution by it of Grenco's payment and performance bonds.

Problems soon began to surface. By letter of March 2, 1961, to Grenco, plaintiff in substance alluded to Grenco's failure to pay Southern Steel Products, Inc., Grenco's reinforcing steel subcontractor, and Oman Construction Company, Inc., its excavation subcontractor, a total of $46,863.55.[5] Plaintiff demanded that Grenco deposit, within 10 days, funds to

[5] In early February 1961, defendant was advised by Southern that while it had "shipped approximately half of the job". Southern had thus far received no payment from Grenco. Later that month Southern presented a claim for $20,836.90 to plaintiff. Oman also then advised plaintiff of its unpaid invoice for $26,026.65.

cover the reserve plaintiff deemed it necessary to establish as a result of Southern's and Oman's claims, and that Grenco afford plaintiff the right to audit Grenco's books and records. On refusal of the right to audit, plaintiff stated, "we will pursue our remedy at law." Plaintiff also stated it would "take immediate steps to exercise joint control of this contract", and threatened "legal steps to impress a trust upon the funds coming out of this contract."

Thereafter, serious problems continued to emerge. By early May 1961, Grenco, even with a time extension of 111 days, was well behind schedule on job progress. Moreover, although defendant had paid to Grenco a total of $193,014.61 (including some $45,000, less retainage, for excavation) on Progress Payment Estimates 1–8, covering the period ending April 15, 1961, Oman, whose earthwork operations were crucial to progress, had ceased work, and had advised Grenco (and plaintiff) it would not go back to work until paid.

Plaintiff was also then aware of complaints by Southern, and by other subcontractors and materialmen, that Grenco had not paid for contract work and materials. Defendant too, then knew of Southern's complaints, and it had also received advice from Standard Iron & Wire Works, Inc., and Ingalls Iron Works Company of Grenco's failure to pay for materials delivered to the Tullahoma project.[6] Defendant was, of course, also aware that Oman's earthwork operations had ceased.

On May 1, 1961, several representatives of defendant met with a representative of Grenco to discuss the status of construction of the Tullahoma project. It was noted that, even with a time extension of more than 100 days, construction was "more or less lagging", and that efforts to bring progress up to, or ahead of, the projected curve should be made. Plaintiff had by then become quite concerned about the situation, and, on May 11, 1961, a representative of plaintiff met with representatives of Grenco in New York with respect to the financial aspects of the matter.

At the May 11, 1961 meeting in New York, Grenco representatives executed a number of documents prepared, or

[6] According to the record, Grenco owed Standard $10,380.86, and Ingalls $36,776, in April 1961.

drafted, by or for plaintiff. The documents included a letter, dated May 11, 1961, from Grenco to defendant, in essence "irrevocably" authorizing and directing defendant to send any payments due Grenco in connection with the Tullahoma project "to the order of Grenco * * * directly to [plaintiff]", an assignment from Grenco to plaintiff, a power of attorney, and a "joint control" agreement.

The "joint control" agreement stated, among other things, that Grenco had "been unable to pay job obligations to job creditors * * * and pursuant to the terms and conditions of its agreement of indemnity with [plaintiff] has been and is in default in connection therewith; and has been unable to progress the work by reason thereof", and that it intended by the "joint control" agreement to afford plaintiff "joint control over all and any of said [contract] funds."

Plaintiff promptly mailed to defendant a copy of Grenco's May 11, 1961 letter. Whether it also then mailed to defendant a copy of each of the other documents signed by Grenco on May 11, 1961, is uncertain, but in any event, defendant was given a complete set of the documents before June 7, 1961, when it made the first of the six progress payments here in issue to Grenco. Accordingly, it is unnecessary to decide what plaintiff sent to defendant immediately after the May 11, 1961 meeting.

In mid-May 1961, plaintiff met a Grenco payroll (or payrolls) in amount of some $4,000, and it made a commitment to Grenco to pay two of Grenco's job creditors (Oman and Southern). On May 15, 1961, plaintiff increased its reserve on the Tullahoma project to $175,000, and on May 16, 1961, plaintiff forwarded to Southern and to Oman a release, together with advice that upon execution and return of the release to plaintiff, the amount Grenco owed the job creditor would be paid. Plaintiff did not, however, pay either Southern or Oman. After June 7, 1961, Grenco paid Southern's claim, and it also paid some (and probably all) of Oman's claim.

On May 19, 1961, Grenco's counsel orally advised plaintiff that Grenco would be unable to meet the project payroll due that day, and that, unless plaintiff wanted to do something about it, the project would have to go into default. Plaintiff

made "no offer". Plaintiff's representatives were then at Grenco's offices in Flushing, New York, for the purpose of determining the estimated costs of completion of the Tullahoma project. After plaintiff's reaction to Grenco's oral advice, Grenco's president received a telephone call. He then told plaintiff's representatives to leave, and they did so.

On May 19, 1961, Grenco addressed letters to plaintiff and to defendant. Grenco's letter to defendant stated, among other things, that "The authorization sent you in our letter of May 11, 1961 is hereby withdrawn", that payments due Grenco should be mailed directly to Grenco, and that any "authorization or claimed authorization which [plaintiff] asserts is canceled." Grenco's letter to plaintiff stated, among other things, that "you do not intend and never did intend to carry out the arrangements of cooperation which were set up between us", that plaintiff's actions had not been in good faith, that Grenco "hereby" canceled and revoked all of the authorizations and powers it had executed on May 11, 1961, and that Grenco had "withdrawn" the instructions contained in its letter of May 11, 1961, to defendant. It is reasonable to infer that Grenco's said letters followed the events described in the preceding paragraph.

By letter of May 19, 1961, to Grenco, with a copy to plaintiff, defendant noted that while progress of the Tullahoma project as a whole was primarily dependent upon the completion of earthwork, no earthwork was in process, and that Grenco's continued delay in proceeding with this phase of the work was adversely affecting the overall job progress. Defendant directed that Grenco take action to improve its progress, and stated that failure to comply with its directive might, in substance, trigger a decision to terminate Grenco's right to proceed with the work.

On May 22 or 23, 1961, representatives of plaintiff and defendant met at the Tullahoma project to discuss Grenco's progress and existing problems. In Tullahoma, Grenco's May 19, 1961 letter to defendant was shown to plaintiff's representatives. Defendant's representatives indicated general satisfaction with the quality of Grenco's work, but not with its quantity. In their view, the crux of the problem was Oman's failure to continue the excavation work. Both plain-

tiff and defendant were aware, at that time, of claims by some Grenco suppliers of Grenco's nonpayment of bills.

By letter of May 24, 1961, to defendant, plaintiff indicated that it regarded Grenco's May 11, 1961 authorization to defendant to send payments in connection with the Tullahoma project to plaintiff as "irrevocable and fully operative, notwithstanding subsequent letter of withdrawal to the contrary." Some time between May 19 and May 25, 1961, however, Grenco's attorney orally asserted to defendant that plaintiff had "breached its agreement" with Grenco.

On May 25, 1961, plaintiff's and defendant's representatives again discussed the progress of the work. The impact of Grenco's financial situation on job progress was at least mentioned. At the end of the discussion, defendant's representatives concluded that plaintiff's representatives were greatly concerned over the situation, and that after they had reported to plaintiff's New York office a decision as to plaintiff's action would be forthcoming. Plaintiff did not, then or thereafter, request that defendant either declare Grenco in default or terminate Grenco's right to proceed.[7]

By May 25, 1961, a progress payment, in the amount of approximately $90,000, was ready to be issued, and the Army Engineer District, Mobile, Alabama, which had jurisdiction over the Tullahoma project, sent a teletype to the Division Engineer, South Atlantic Division, Atlanta, Georgia, seeking instructions with respect to the progress payment. The said teletype alluded to Grenco's letters of May 11 and May 19, 1961, to defendant, plaintiff's May 24, 1961 letter to defendant, and to Grenco's oral advice that it was legally entitled to, and needed, the progress payment. It also stated, among other things, that several of Grenco's suppliers and subcontractors had accounts due and unpaid; that Grenco was behind schedule; that Grenco might be forced into default through failure to receive a current payment; that, if made, the payment might not be enough to satisfy all claims; that plaintiff might refuse to take over and complete

[7] By letter of September 8, 1961, to defendant, plaintiff did state that it was considering taking over the work. On that same day, however, the Mobile District Engineer requested of his superiors authority to terminate Grenco's right to proceed.

the work; and that there was no "formal assignment under the contract."

On or about June 1, 1961, plaintiff requested that Washington counsel ascertain whether the $90,000 progress payment referred to above had been made. There followed, during the period June 1–7, 1961, an extensive and involved series of communications between plaintiff and defendant, between Grenco and defendant, and between the Office of the Chief of Engineers, Washington, D.C. and Corps of Engineers offices in Atlanta and Mobile. So far as the findings show, however, there was a notable lack of communications betweeen plaintiff and Grenco during the period May 19, 1961 to June 7, 1961, when defendant's decision to deliver the progress payment check to Grenco was made.

The events of June 1–7, 1961, are fully detailed in the findings. Briefly, plaintiff maintained throughout that period that the progress payment check should be delivered to plaintiff, not to Grenco. Defendant, which had already held up the check for about a week, was under increasing pressures from another direction as well. On June 5, 1961, it was advised that Grenco had to have money to keep going; that Grenco had made arrangements to get its subcontractors back on the job;[8] that all major subcontract work on the project had ceased, that only a small crew was working, and that within 48 hours all contract work would stop; that Grenco's subcontractors were refusing to proceed because of failure to receive payments; that Grenco was accusing defendant of breach of contract; that if defendant did not pay over the current payment Grenco would be forced to shut down the job; that, if Grenco did so, there was no indication plaintiff would take over the work; and that, in view of Grenco's low bid, excess costs on readvertisement would for that reason alone be considerable.

The facts reflect that during this period defendant considered withholding all progress payments until plaintiff and Grenco could reach an agreement on check delivery, or until the matter could be resolved by litigation, and that

[8] The implication that payment to the subcontractors was a prerequisite to their return to work is, on this record, patent.

defendant did endeavor, albeit unsuccessfully, to have the disputants resolve their differences themselves.

Both plaintiff's main office and Grenco's office were in New York. On June 1, 1961, the Office of the Chief of Engineers suggested to the contracting officer that he arrange an immediate meeting with plaintiff and Grenco to resolve, if possible, the problem of where payments to Grenco should be mailed. On June 2, 1961, the Mobile Army Engineer District orally asked plaintiff's New York office whether any agreement had been reached, and indicated that absent some agreement defendant would be forced to make the payment to Grenco. Plaintiff's response was that no agreement with Grenco could be reached, but that release by defendant of the check to Grenco would be at defendant's peril. The facts also reflect that defendant gave careful consideration to the question whether the "assignment" from Grenco to plaintiff complied with the Assignment of Claims Act, 31 U.S.C. § 203, and there is no contention that, in answering that question in the negative, defendant erred. Indeed, plaintiff implicitly concedes that any rights it may have herein must derive from the "joint control" agreement and an asserted abuse of discretion, not from the "assignment."

On June 7, 1961, the Office of the Chief of Engineers instructed the Mobile Army District Engineer, through the South Atlantic Division, that absent a proper assignment the progress payment check should be delivered to Grenco, and the check was in fact airmailed to Grenco in New York on June 7. Plaintiff was promptly so advised.

Following June 7, 1961, Grenco got Oman to return to the job, and advised defendant (erroneously, as it turned out) that all claims "against" the Tullahoma project had been satisfied. Its financial situation remained "tight", however, and in early July 1961 defendant approved "bi-weekly" progress payments to Grenco in lieu of making them at approximate monthly intervals as theretofore.

Following June 7, 1961, Grenco also made payments, totaling some $62,000, to Southern, Oman, and Ingalls, and it met its payrolls for a time, applying at least $50,000 of the monies paid to it by defendant on and after June 7, 1961, to

Tullahoma project payrolls. Although Grenco's overall actual completion remained behind schedule, it was, by early August 1961, working 6 days a week, 10 hours per day, and making excellent progress on the work. As the findings reflect, however, serious problems remained.

By letter of August 30, 1961, to plaintiff, Grenco stated that it desired a "loan guaranteed in the amount of $200,000", to be repaid at the rate of $25,000 per month. Grenco proposed to sign over the monies due it on the Tullahoma project to a recognized financial institution, and stated that "we also hereby authorize" plaintiff to countersign Grenco checks for payments and obligations under the Tullahoma project contract. The record contains no formal reply by plaintiff to Grenco's August 30, 1961 letter, but plaintiff did decline to guarantee any such loan to Grenco.

By letters of September 7, 1961, plaintiff communicated with three banks, two in New York and one in Tullahoma. Each of plaintiff's letters alluded to a completed or imminent advance of funds to Grenco on the strength of the Tullahoma project contract; stated that any monies advanced on the strength of documents relating to the project were trust funds subject to plaintiff's joint control, and that any assignment from Grenco would be subordinate to plaintiff's rights; and advised that plaintiff would enforce its agreement of indemnity with Grenco by legal action if need be.

On September 8, 1961, shortly after receiving advice from Grenco's Range Tube[9] supplier that Grenco owed it some $74,000 for materials delivered to the Tullahoma project, and that it had received no payments from Grenco, defendant sought a conference with Grenco and plaintiff. Also on September 8, 1961, plaintiff wrote to defendant (with a copy to Grenco) to say, among other things, that the Tullahoma situation had deteriorated; that its rights as surety were

[9] The Range Tube was a major component of the Gas Dynamics Facility Hyperballistics Range, with an estimated cost of $196,072. In payment estimates for the periods ending July 10 and July 25, 1961, Grenco had included $35,000 under Feature Control Item No. 5, Range Tube. In Payment Estimate 14, covering the period August 11–25, 1961, Grenco included an additional $25,000 under Feature Control Item No. 5.

"being jeopardized by our principal's failure to perform"; that it had the right, under its agreement of indemnity with Grenco, to declare Grenco in default and to take over the work and arrange for its completion; and that it was considering implementing that agreement. A meeting with defendant was requested.

On September 14, 1961, representatives of plaintiff, defendant, and Grenco met at Grenco's offices in New York. In the interim, defendant had decided that unless the forthcoming conference produced satisfactory arrangements for expediting the contract work and regaining progress efficiency, Grenco's right to proceed should be terminated. The September 14, 1961 meeting was essentially unproductive, and by letter of September 19, 1961, defendant terminated Grenco's right to proceed effective September 20, 1961, and declared Grenco in default.

Between June 7 and September 19, 1961, defendant paid to Grenco six progress payments totaling $254,064.83. The June 7 progress payment amounted to a little more than $81,000; the remaining five progress payments totaled approximately $173,000. The last payment estimate paid to Grenco covered the period August 10–25, 1961. While the check in payment therefor, for $45,426.71, was dated August 30, 1961, the evidence suggests that it was in fact released to Grenco a few days thereafter.

Following September 19, 1961, plaintiff obtained a contractor to complete the Tullahoma project, and the project was completed and accepted by defendant July 12, 1963. Plaintiff expended some $300,000 under its performance bond and some $386,000 under its payment bond, in connection with Grenco's Tullahoma project contract.

III.

The Issues Framed by the Court's Order

The court's order of remand poses the questions whether defendant, in making the progress payments in question to Grenco, acted in good faith and primarily to promote the continuation of the contract work, and whether, in light of all the facts and circumstances, defendant's actions were a

reasonable exercise of its discretion or an arbitrary disregard of plaintiff's rights as surety and an abuse of such discretion.

It is clear both that defendant's good faith in making the said progress payments to Grenco cannot seriously be challenged, and that defendant's actions had as their primary purpose promotion of the continuation of the contract work. Indeed, analysis of plaintiff's arguments reveals that plaintiff does not really contend to the contrary. Its position, rather, is that defendant's good faith and primary purpose "are not the governing factors in this matter since its actions were not a reasonable exercise of its discretion under all these circumstances", and that the same facts justifying that conclusion also establish an arbitrary disregard of plaintiff's rights as surety and an abuse of discretion.

With commendable forthrightness, defendant recognizes that when the facts and circumstances are viewed objectively "there is no ready answer to the questions posed by the Court in its Order of October 20, 1972," and that these questions are troublesome and difficult ones. In defendant's view, however, there was not abuse of, but rather a reasonable exercise of, discretion in all the circumstances, with due regard to plaintiff's interests as surety, not arbitrary disregard thereof.

In evaluating the conflicting positions of the parties, it is critical to note at the outset that the Tullahoma project was far from completion at the time defendant paid the sums here in controversy to Grenco. Thus, the issue is wholly unrelated to which of two or more competing claimants is entitled to receive a final contract payment. Nor was defendant "merely a stakeholder, its interest * * * satisfied once the project was completed", but a contractually bound, and vitally interested, party to an ongoing construction project. *United States Fidelity & Guar. Co.* v. *United States*, 201 Ct. Cl. 1, 13, 475 F. 2d 1377, 1384 (1973). See also *Argonaut Ins. Co.* v. *United States*, 193 Ct. Cl. 483, 434 F. 2d 1362 (1970); *Fireman's Fund Ins. Co.* v. *United States*, 362 F. Supp. 842 (D. Kans. 1973); *United States* v. *Continental Cas. Co.*, 346 F. Supp. 1239 (N.D. Ill. 1972).

As this court said in *Argonaut*, *supra*, 193 Ct. Cl. at 493–94, 434 F. 2d at 1367–68:

> During performance, the Government's role is substantially different from that of a mere stakeholder of a final contract payment. The defendant has an important interest in the timely and efficient completion of the contract work. In furtherance of this interest, the Government contracts for a broad range of rights which are designed to promote continuation of the contract work. These provisions give the Government considerable discretion and flexibility in administering the contract. Public policy supports this flexibility in light of the various unforeseen circumstances which may hinder performance.

Notwithstanding its own interests, however, defendant has a clear duty, even during the performance of the contract, to exercise its discretion responsibly, and to consider the interests of a surety in conjunction with the other problems it may encounter in the administration of the contract. *Argonaut Ins. Co.* v. *United States*, *supra*. As the court put it in *United States Fidelity & Guar. Co.* v. *United States*, *supra*, defendant must balance its own interests in proceeding with the contract against possible harm to the surety. Thus, the crucial question is whether there was, in this case, a reasonable and responsible exercise of discretion in the decision not to deliver progress payment checks to plaintiff, but to make progress payments directly to Grenco.[10]

The standard of proof to be applied in a case where an arbitrary and capricious disregard of the surety's interests, and an abuse of discretion, are charged must be, and is, high. See *Keco Indus., Inc.* v. *United States*, 192 Ct. Cl. 773, 428 F. 2d 1233 (1970). Where, as here, defendant is entitled to exercise its discretion, "plaintiff has an unusually heavy burden of proof in showing that the determination made * * * was arbitrary and capricious." *Continental Bus. Enterprises, Inc.* v. *United States*, 196 Ct. Cl. 627, 637, 452 F. 2d 1016, 1021 (1971). See also *Excavation Constr., Inc.* v. *United States*, 204 Ct. Cl. 299, 494 F. 2d 1289 (1974); *Eggers &*

[10] This statement of the issue treats all of the six progress payments as made under essentially identical circumstances. While defendant suggests differing treatment is sounder, this approach suffices for present purposes.

Higgins v. *United States*, 185 Ct. Cl. 765, 784, 403 F. 2d 225, 235 (1968).

Plaintiff vigorously asserts that defendant not only was of the opinion that it had no discretion to exercise, and thus exercised none, but in any event failed to consider at all a number of factors which made completion of the Tullahoma project by Grenco impossible. According to plaintiff, all defendant had to do in this case was simply to honor Grenco's May 11, 1961 authorization, and, it urges, defendant's failure to do so here amounted to arbitrary and capricious disregard of plaintiff's rights.

As will be seen, plaintiff's position is far too simplistic. As defendant properly suggests, when the facts and circumstances of the case are viewed objectively, the factors relevant to a conclusion with respect to abuse of discretion *vel non* do not point unmistakably to any clear and simple answer. The issue is exceedingly complex, and very close.

Shortly after Grenco's May 11, 1961 authorization to defendant to send checks payable to Grenco in care of plaintiff, Grenco advised both plaintiff and defendant that it had rescinded that authorization. In May 1961, Grenco also advised defendant that plaintiff had breached an agreement with Grenco. Grenco also made it clear to plaintiff at that time that, in Grenco's view, plaintiff had failed to comply with its obligations to Grenco. Grenco's said actions followed its oral advice to plaintiff that unless plaintiff wanted to do something about Grenco's inability to meet a payroll, the project would have to go into default, and it is reasonable to conclude that they were precipitated by the fact that, in response, plaintiff made "no offer".

Thus, without regard to the rightness, or wrongness, of Grenco's and plaintiff's respective positions, defendant, in a very real sense, was caught between the conflicting demands of Grenco, to whom it had an explicit contractual obligation, and of plaintiff. Plaintiff's rights as against defendant were not contractual in nature, but purely equitable, and were to be considered "in the exercise of equitable discretion and with due regard to the legal and equitable rights of others." *Argonaut Ins. Co.* v. *United States*, *supra*, 193 Ct. Cl. at 493, 434 F. 2d at 1367.

In late May 1961, both plaintiff and defendant were well aware of claims by Grenco's subcontractors and suppliers of Grenco's nonpayment of bills. In defendant's view, the quality of Grenco's work was good, although the quantity of Grenco's performance was less than satisfactory, and plaintiff was, or should have been, aware of that view. Plaintiff did not, then or at any time thereafter relevant here, ask defendant to declare Grenco in default, or to terminate its right to proceed.

The Tullahoma project was not an insignificant one. Indeed, plaintiff itself later alluded to the obvious importance of the project to defendant, and to the apparent urgency that there be no interruption in the progress of the work. When defendant's representatives in charge of the project became embroiled in the dispute between Grenco and plaintiff, they promptly sought instructions with respect to disposition of the progress payment.

The process of decision, which commenced May 25, 1961, with the request for instructions alluded to above, took some 2 weeks. During that period defendant was aware that work on the project had come to a virtual standstill, and there is clear indication in the record that absent a payment by defendant to Grenco it would shut the job down in a day or two at most. Grenco was simultaneously accusing defendant of breach of contract, and the accusation was plainly not without force. *Argonaut Ins. Co.* v. *United States*, *supra*, 193 Ct. Cl. at 492, 434 F. 2d at 1366–67; *Fireman's Fund Ins. Co.* v. *United States*, *supra*, 362 F. Supp. at 846. As the court said in the latter case,

> It is common knowledge that contractors rely upon contract proceeds administered through progress payments to properly finance the contract. The government cannot lightly withhold funds the contractor may need for this purpose.

In defendant's view, the crux of the problem of lagging job progress was the failure of Oman to continue excavation work on the project. During the process of decision, defendant was told that Grenco had made arrangements to get its subcontractors back to work, and Oman in fact did

return to work on the Tullahoma project shortly after June 7, 1961.[11]

Even where defendant knows that a government contractor has serious financial difficulties, defendant does not become obligated either to withhold progress payments or to declare the contractor in default at the surety's request—and no such request was made here—so long as the progress of the contractor on the job is satisfactory to defendant and it has good reason to believe that the contract will be completed. *United States Fidelity & Guar. Co.* v. *United States*, *supra*; *Argonaut Ins. Co.* v. *United States*, *supra*; *United States* v. *Continental Cas. Co.*, *supra*, 346 F. Supp. at 1244. The record reflects no valid basis for a conclusion by defendant in early June 1961, that Grenco could not complete the project, and Grenco in fact did make substantial progress toward completion of the work for a considerable period of time thereafter.

Despite plaintiff's argument to the contrary, defendant also considered the fact that Grenco's bid had been far less than that of the next lowest bidder, and that excess costs on readvertisement would, for that reason alone, be considerable. Since plaintiff was Grenco's performance bond surety as well as its payment bond surety, consideration of this element was appropriate, if not essential. "* * * [I]t is superior policy, as far as the Government's interest in the cheapest and most rapid completion of the contract is concerned, to keep the original contractor going as long as possible, even when he encounters financial difficulty." *United States* v. *Continental Cas. Co.*, *supra*. And, defendant's and plaintiff's interests in performance coincided to a considerable degree.

During the process of decision, throughout which defendant did withhold the first progress payment here in suit, it also considered withholding all progress payments until plaintiff and Grenco could reach agreement on check delivery, or until the dispute between them could be resolved by legal action.[12] Defendant in fact made some effort, if not a vigorous one, to have Grenco and plaintiff, both located in

[11] Following June 7, 1961, Grenco paid Oman some, and probably all, of its claim.

[12] In March 1961 plaintiff had threatened, but did not then or thereafter initiate, action against Grenco.

New York, resolve their differences themselves. In view of Grenco's assertion of a breach of contract by defendant, and plaintiff's advice that no agreement could be reached with Grenco, the possibility of resolution of plaintiff's and Grenco's dispute by mutual agreement was obviously not a viable one, and, even with hindsight, government-initiated litigation appears to be no better solution.

As plaintiff asserts, defendant's telegraphic communications during the period June 1–7, 1961, do contain statements to the effect that, absent a valid assignment by Grenco to plaintiff, the first of the several progress payment checks here in suit should be delivered to Grenco. As the foregoing recitation of facts demonstrates, however, plaintiff's argument that defendant therefore considered *only* whether or not it should recognize the "assignment" to plaintiff not only does not follow, but is patently unsound. While explication of defendant's reasons for the decision would clearly have been preferable, plaintiff's charge of no exercise of discretion at all must be, and is, rejected. See *Andrade* v. *United States*, 202 Ct. Cl. 988, 998, 485 F. 2d 660, 665 (1973); *Grover* v. *United States*, 200 Ct. Cl. 337, 344 (1973).

What emerges from the record, on analysis, is not a governmental decision reached in the absence of any exercise of discretion and solely on the basis of a determination whether or not plaintiff had a valid assignment, within the meaning of 31 U.S.C. § 203, from Grenco, but rather a careful consideration of a significant number of factors related both to defendant's interest in the timely and efficient completion of the contract work and to plaintiff's interests as surety.

It should be noted, however, that the course of action pursued by both defendant and by plaintiff in this case should not serve as any model for the resolution of future disputes between a surety and the government with respect to progress payments due a contractor in difficulty, and that there are some puzzling, and troublesome, gaps in the record.

Defendant's failure of explication of reasons for its decision to pay Grenco directly has been alluded to hereinabove. The findings fail to indicate that defendant, with knowledge in June 1961 of Grenco's problems, obtained or even sought from Grenco any commitment, formal or otherwise, with re-

spect to the application of progress payments to the Tullahoma project, nor did defendant, at any time here relevant, meet jointly with plaintiff and Grenco in an effort to resolve the impasse in which it found itself.

Plaintiff's actions and inactions are also difficult to understand. Although plaintiff had come to the conclusion, by May 23, 1961, that defendant would make payments directly to Grenco, the findings reflect no effort whatever on plaintiff's part thereafter to obtain from Grenco any commitment with respect to the application of progress payments to the Tullahoma project. Nor, at any time here relevant, did plaintiff initiate any action against Grenco to enforce plaintiff's considerable rights under Grenco's agreement of indemnity with plaintiff.

Indeed, the absence of any meaningful communications between plaintiff and Grenco during the period May 25–June 7, 1961, and thereafter, is striking. *Cf.* Brady, *Bonds on Federal Government Construction Contracts: The Surety's View*, 46 N.Y.U. L. Rev. 262, 278–79 (1971). And, for the period June 8, 1961 to August 31 or September 1, 1961, when the last of the progress payments here in suit was probably made, the findings contain no evidence of any real concern by plaintiff as to Grenco's progress on the Tullahoma project. Throughout the latter period plaintiff simply waited to see what developed, so far as the record shows.

Be the foregoing matters as they may, proof in this case has now been closed on two separate occasions, and it must be decided on the basis of the evidence of record. While the issue is close, and while any resolution of it could not fairly be described as free of doubt, it is concluded that in the light of all the facts and circumstances plaintiff has proven neither an arbitrary and capricious disregard by defendant of plaintiff's equitable rights as surety, nor an abuse by defendant of its discretion.

IV.

The Parties' Other Contentions

Plaintiff also contends, among other things, as it did before the court in 1972, that Grenco was, to defendant's

knowledge, in default of both its performance and payment bond obligations on May 11 and June 7, 1961; that, there being "default under the contract when there is default under the bond", Grenco was also in breach of its contract with defendant; that, upon Grenco's default, plaintiff acquired well-recognized rights in the funds held by defendant; and that plaintiff had a classic, irrevocable "power coupled with interest".

Defendant, in turn, also reiterates, albeit in expanded form, arguments it made to the court in 1972: laches, estoppel, waiver, ratification, accord and satisfaction. Too, in recognition of the equitable nature of the rights plaintiff asserts, defendant vigorously urges that plaintiff's failure to take any action whatever in the nature of self-help (*e.g.*, an action *quia timet* [13] to compel correct conduct by Grenco) should lead to denial of any recovery herein.

To the extent the foregoing contentions have heretofore been urged upon the court, they have, by clear implication, been held not dispositive of the rights of either party to this cause. Accordingly, they need not be discussed herein. The sole new matter is defendant's *quia timet* argument. While plaintiff's response (that any attempt to obtain *indemnification* from Grenco would have been futile, and that any relief plaintiff could have obtained from a court would have been identical to that provided in the May 11, 1961 documents) seems weak, it is also unnecessary, in view of the holding hereinabove, to rule on this contention.

V.
Conclusion

In all the facts and circumstances of this case, (1) defendant acted in good faith and primarily to promote the continuation of the contract work in making the progress payments to Grenco, and (2) no arbitrary disregard of plaintiff's rights as surety, nor any abuse of defendant's discretion has been proven. Accordingly, plaintiff is not entitled to recover.

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[13] See *Western Cas. & Sur. Co.* v. *Biggs*, 217 F. 2d 163 (7th Cir. 1954); Morris, *A Surety Lawyer's Viewpoint*, 2 Pub. Cont. L.J. 79, 82 (1968).

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CONCLUSION OF LAW

Upon the findings of fact and opinion, which are adopted by the court and made a part of the judgment herein, the court concludes as a matter of law that plaintiff is not entitled to recover and the petition is dismissed.

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530 F. 2d 1342

ROBERTS DAIRY COMPANY, OLIVER TRACY, EYNON JONES, LOUIS DUNHAM, EDWARD JOHNSON AND PREP FOODS, INC. v. THE UNITED STATES; MILTON G. WALDBAUM CO., AND MARSHALL FOODS, INC. (FORMERLY MARSHALL PRODUCE CO.), ET AL., THIRD PARTY DEFENDANTS

[No. 257-69. Decided January 28, 1976]

ON THE PROOFS

Patents; scope of specification and claims; infringement; validity; dehydrated egg products.—Plaintiffs seek reasonable and entire compensation for the alleged unauthorized use and manufacture by or for the United States of egg products disclosed and claimed in U.S. patents Nos. 3,113,872 and 3,093,487. Certain companies who produced egg products for the United States have been named third-party defendants. The inventions embodied in the patents in suit are directed to destroying pathogenic bacteria (i.e., salmonella), and to an improved additive-free process enhancing the keeping properties of eggs by preventing during storage the "browning reaction" caused by the natural reducing sugar in the eggs chemically reacting with the egg protein, and eliminating development of a bitter flavor, and also eliminating coagulation of the albumen during processing. It is *held* (1) that production by third-party defendants Monark Egg Products, Inc. and Milton G. Waldbaum Co. of egg products for the United States under the provisions of the 1965 military specification infringes claim 1 of patent 3,113,872, but that a license from plaintiffs to both companies renders plaintiffs' claim moot; (2) that aside from (1) claim 1 of patent 3,113,872 has not been infringed; (3) that production by A. J. Pietrus & Sons Co. of egg products for the United States under the provisions of the 1965 military specification infringes patent 3,093,487, but a license from plaintiffs to Pietrus renders plaintiffs' claim moot; (4) that production by Southwestern Egg Producers of egg products for the United States under USDA specifications PY-38 and PY-45

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infringes patent 3,093,487; (5) that aside from (3) and (4) patent 3,093,487 has not been infringed; (6) that claims 1–5 of patent 3,093,487 are invalid under 35 U.S.C. § 103; and (7) that claim 1 of patent 3,113,872 is valid. Plaintiffs are not entitled to recover and the petition is dismissed.

Patents; specification and claims; construing and interpreting.

[1] Claims are to be construed in light of the specification and both are to be read with a view to ascertaining the invention. A patentee is bound by his specification in interpreting his patent claims even when the specification requires a narrower interpretation of the claims than he desires.

Patents ⇐ 167(1)

Patents; specification and claims; construing and interpreting.

[2] The specification is to be looked to as the concordance for the claims; the claims being construed in accordance with the specification in order to distinguish them from the prior art and to thus avoid invalidity.

Patents ⇐ 167(1)

Patents; specification and claims; construing and interpreting; Patent Office proceedings.

[3] The claims of a patent are necessarily construed in connection with the other parts of the patent instrument, as well as the circumstances surrounding the prosecution of the patent application through the Patent Office.

Patents ⇐ 167(1)

Patents; claims; construing and interpreting; limitations placed in claims.

[4] Limitations made in claims to gain allowance thereof are of the utmost importance and cannot be ignored in a later suit in favor of a broader claim scope.

Patents ⇐ 165(1)

Patents; infringement; process patents.

[5] A patent for a method or process is not infringed unless all steps or stages, or equivalents thereof, of the claims of the patent in suit are utilized or practiced by the alleged infringer.

Patents ⇐ 229

Patents; pleading and practice; infringement; burden of proof.

[6] A patent owner has the burden of proving infringement by a preponderance of the evidence.

Patents ⇐ 312(4)

Patents; Court of Claims jurisdiction; patent infringement; licensee.

[7] Suit against the United States in the Court of Claims under 28 U.S.C. § 1498 is proper only when the alleged infringement is accomplished by the United States, or a United States contractor, without a license to practice the invention. Where a contractor has

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been licensed under the patents in suit, the patent owner-licensor is barred from bringing suit even if the contractor failed to pay royalties as required by the license agreement.

Courts ⇐ 449(3)

Patents; validity; presumption of validity.

[8] Reliance upon a multitude of prior art references in attempting to establish obviousness of an invention buttresses the statutory presumption of validity.

Patents ⇐ 112.1

Patents; validity; presumption of validity; rebuttable presumption.

[9] The failure of the Patent Office to consider important prior art references while evaluating patentability of a pending application may be enough to overcome the statutory presumption of validity of an issued patent.

Patents ⇐ 112.1

Patents; patentability; obviousness; generally.

[10] While the ultimate question of patent validity is one of law, in resolving whether or not a patent meets the requirements of patentability set forth in 35 U.S.C. § 103, consideration must be given to the scope and content of the prior art, the difference between the prior art and the claims in issue, and the level of ordinary skill in the pertinent art. In addition, secondary considerations, such as commercial success, satisfying a long-felt need, and failure of others are relevant considerations.

Patents ⇐ 16.7, 18, 36.2(1)

Patents; claims; construing and interpreting; broad or narrow.

[11] The Court of Claims has consistently favored construction of a patent claim that will render it valid over a construction that would render it invalid.

Patents ⇐ 157(2)

Richard A. Huettner, for plaintiff. *Francis T. Carr*, attorney of record. *Kenyon & Kenyon Reilly Carr & Chapin*, of counsel.

D. C. Bradford, III, attorney of record, for the third parties, Milton G. Waldbaum Co. and Marshall Foods, Inc. (formerly Marshall Produce Co.). *Bradford and Bloch*, of counsel.

Michael W. Werth, with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Before COWEN, *Chief Judge*, DAVIS and KASHIWA, *Judges*.

Opinion of Trial Judge

PER CURIAM: This case comes before the court on plaintiffs' exceptions to the recommended decision filed May 29, 1974, by Trial Judge Joseph V. Colaianni, pursuant to Rule 134 (h), having been submitted to the court on the briefs and oral argument of counsel. Upon consideration thereof, since the court agrees with the recommended decision, as hereinafter set forth*, it hereby affirms and adopts the same as the basis for its judgment in this case. Therefore, it is concluded that plaintiffs are not entitled to recover and their petition is dismissed.

OPINION OF TRIAL JUDGE

COLAIANNI, *Trial Judge:* Plaintiffs' original petition sought recovery under 28 U.S.C. § 1498 of reasonable and entire compensation for the unauthorized use and manufacture by or for the United States of certain egg products which were alleged to be covered by United States Letters Patent No. 3,113,872 (hereinafter referred to as '872), entitled "Method of Treating Shelled Eggs," issued December 10, 1963, on an application filed January 26, 1960, by Eynon Jones and Albert R. Johnson, and United States Letters Patent No. 3,093,487 (hereinafter referred to as '487), entitled "Egg Products and Processes for Preparing Same," issued June 11, 1963, on an application filed February 27, 1961, by Eynon Jones, Oliver H. Tracy, and Clarence B. Deffenbaugh.

Plaintiffs also sought recovery under 28 U.S.C. § 1491 of damages for defendant's use or manufacture of plaintiff's inventions during 1960 and 1961 while plaintiffs' patents were still pending in the Patent Office. During the course of pretrial discovery, plaintiffs withdrew that portion of their petition which pertained to the contract counts under 28 U.S.C. § 1491.

The '872 patent is wholly owned by Prep Foods, Inc. The '487 patent is jointly owned by Eynon Jones, Oliver H. Tracy, Roberts Dairy Co., Lewis R. Dunham, and Edward

*Whereas the court adopts the trial judge's separate findings of fact, which are set forth in his recommended decision, filed May 29, 1974, they are not printed herein since such facts as are necessary to the decision are contained in his opinion.

Johnson. All of the above owners joined in this lawsuit as plaintiffs.

As a result of notices issued by the court under the provisions of Rule 23(b), now Rule 41, at defendant's request, nine third-party defendants entered an appearance in this suit. These nine parties were: (1) A. J. Pietrus & Sons Co., (2) Harp's Green Valley Farms, Inc., (3) Henningsen Foods, Inc., (4) Marshall Foods, Inc. (formerly Marshall Produce Co.), (5) Mid-Central Egg Products, Inc., (6) Milton G. Waldbaum Co., (7) Monark Egg Products, Inc., (8) Southwestern Egg Producers (hereinafter referred to as SWEP). and (9) Tranin Egg Products Co. Because of plaintiffs' decision not to present evidence of alleged infringement against Henningsen Foods, Inc., and Tranin Egg Products Co., these parties were dismissed from this action without costs or attorneys' fees. Mid-Central Egg Products, Inc., is now a division of Monark Egg Products, Inc., and the defense of the former has been wholly taken over by the latter.

Third-party defendants Marshall Foods, Inc., Milton G. Waldbaum Co., and A. J. Pietrus & Sons Co. were each represented by counsel at trial, and each has filed proposed findings of fact and a brief in support of their positions.

The only issues under consideration relate to patent validity and infringement since, by agreement of the parties, the issue of accounting has been deferred until after liability is established.

I. *Background*

The subject matter of the present litigation involves egg products which are allegedly produced in accordance with the steps outlined in the hereinafter-stated claims. Although the claims do not indicate what is done to the products after they are treated in accordance with the claimed processes, the specifications of the patents in suit disclose that the products are then dehydrated, packed and sold in commerce as instant egg or powdered egg products. A purchaser has only to add water to the instant egg or powdered egg material to obtain a product that is similar, both in appearance and taste, to freshly shelled eggs.

The principal constituents of an egg are the white and the yolk. Egg white is essentially fat-free and consists of about

88% water, 11½% protein and the remainder, minerals and natural reducing sugar, which, although only about 1% or less, is extremely significant for reasons which will hereinafter be discussed. The yolk contains almost all the fat content of the egg and comprises about 49% water, 33% fat and 16% protein.

The yolk fat, on the other hand, consists of approximately one-third saturated fats and two-third unsaturated fats. The unsaturated fats have a lower melting point than the saturated fats and the viscosity (resistance to flow) of the fats vary inversely with temperature. Thus, as the temperature increases, the viscosity decreases and the fats become more free-flowing at higher temperatures.

Eggs may become contaminated with various microbiological organisms which are pathogenic to man. Included among these organisms is salmonella, which is known to have over 1,300 different varieties. Salmonella poisoning, which usually results in an upset digestive system with accompanying intense vomiting and diarrhea, can be fatal to the very young and the very old.

Salmonella, which can be present in the intestines of animals, may find its way into an egg through a crack in the shell. Since salmonella can also be present in the intestines of humans, it may get into bulk shelled eggs in a processing plant through a plant worker who is a carrier of the organism. To this day, salmonella continues to be considered a fairly serious health hazard in the United States.

However, salmonella can be destroyed by subjecting an egg to heat, above a base line figure which is generally taken as 140° F., for a predetermined length of time. A time/temperature relationship for destroying salmonella has been worked out. Specifically, an exposure of 15–20 minutes is necessary for a temperature setting of 140° F., a 3½ minute exposure is necessary at a temperature of 150° F., but only a 1 or 2 second exposure is required at a temperature of 160° F.

Water is a necessary ingredient for the multiplication of salmonella. The absence of water, such as when an egg product is converted to a dried powder form, inhibits the growth of salmonella. The absence of water will, however, not result

in the destruction of the salmonella; instead, it exists in a dormant state and resumes its growth upon reconstitution by the addition of water. While tests have shown that salmonella also becomes dormant at a temperature below 40° F., it has also been determined that the salmonella is not destroyed by subjecting the egg product to freezing temperatures.

The dried egg products produced during World War II were manufactured without any steps being taken to kill the pathogenic bacteria which might be present. Instead, the eggs, after being broken and mixed, were sent directly to a spray drier without any further processing. The outgoing product left the spray drier at a temperature of approximately 130° F., which was too low a temperature to accomplish pasteurization, and, therefore, any salmonella present in an egg processed in such a manner would remain alive but dormant in the dried egg product that resulted.

The failure to destroy salmonella did not present a problem for ingredient products, *i.e.*, products which were subsequently intended to be incorporated into baked products, since the temperature to which the baked products was raised would greatly exceed the temperature necessary to kill any dormant salmonella. However, in those instances where the product manufactured was not to be subjected to a subsequent baking step, but was instead intended to be reconstituted into its former state by the addition of water, such as would be the case if one wished to prepare a scrambled egg, a potentially serious problem existed. Specifically, if the powdered egg product was contaminated with dormant salmonella, upon reconstitution the salmonella would be reactivated, and the temperature reached by the scrambled eggs prepared in a skillet or in a steam table used for mass feeding would be too low to kill the reactivated salmonella. Not only would the temperature to which the scrambled egg was raised be too low to kill the salmonella, it would be in the range that was favorable for its growth. This explains why salmonellosis is often associated with the mass feeding that the Armed Forces must necessarily employ.

Storage of dried eggs which were produced by processes prevalent during World War II also presented problems.

The dried eggs would in time change in color from yellow to brown, and develop an extremely bitter flavor that made them inedible. These changes resulted, it was later learned, from a "browning reaction" which was caused by the natural reducing sugar in the egg chemically reacting with a portion of the egg protein. The "browning reaction" was found to continue even though the egg was in the dry state, and stored at ambient temperatures.

To remove the reducing sugar from the powdered egg and thus prevent the "browning reaction" from occurring, desugaring processes were developed. The desugaring methods used microbiological agents such as yeast to consume the natural sugar in the egg white during a fermentation step. In an alternative method, the enzyme utilized by the microbiological agent could be employed directly for this purpose. Unfortunately, both methods, although they solved the "browning reaction," aggravated the problem of salmonella contamination, if it was present in the product, by requiring that the product be held for several hours at temperature levels which were ideal for the rapid growth of salmonella. The desugaring operation, by requiring another step, increased the cost of producing powdered eggs. Also, the desugaring operation increased the cost of producing powdered eggs because of the additional ingredients needed in carrying out the added step.

Although the "browning reaction" experienced by dried eggs produced by older processes was thus susceptible of solution, the problem of destroying the salmonella contamination remained. As previously discussed, salmonella can be destroyed by the application of a high level of heat over a precalculated length of time. However, it is important to be able to accomplish pasteurization without ill-effects on the egg product. Particularly, 140° F., which is at the lower end of the temperature range for killing salmonella, is very close to the temperature at which the egg white protein, which differs from and is more heat sensitive than egg yolk protein, commences to denature or coagulate (cook).

Denaturation of an egg results in changes in the helical shape of the egg protein molecule, such that the molecules of bound water normally held therein are released. As a result,

the egg white protein loses its ability to take on water or rehydrate and thus, when the dry egg is reconstituted with water, the final product will not have the textural appearance of an acceptable product.

In addition to the damage to the product if denaturation is permitted, the egg protein as it coagulates tends to build up on the pasteurizer plates, in those instances where hot plate-type pasteurizing equipment is used, during production and can reduce or stop the flow of the product through the equipment.

II. *The Patents in Suit*

The inventions embodied in the patents in suit are directed at overcoming all of the above-discussed problems.

In particular, the '872 patent discloses an invention for treating shelled eggs that enhances their keeping qualities and removes objectionable flavor and odors. The patentees were particularly concerned over the lack of a commercially practicable method that would enable the storage of egg products for a long period of time without spoilage or waste. The patent refers to a number of prior attempts to pasteurize eggs that, for one reason or another, proved to be unsuccessful. Specially, the patentees indicate that processes employing additives, such as hydrogen peroxide combined with a catalase enzyme, have proven to be of limited success in the egg drying field.

Similarly, the patentees explained that processes that employed additives to elevate the coagulating temperature of albumen (approximately 140° F.) to a level where the egg product could be effectively pasteurized (between 140° and 165° F.) had not been successful. Moreover, prior art attempts to improve the keeping properties of shelled eggs, without additives, by a two-step heat treatment process were effective for the killing of only certain types of bacteria.

The inventions involved in this suit were thus directed to an improved additive-free process which would enhance the keeping properties of eggs, eliminate coagulation of the albumen, and prevent denaturation of proteins in the egg product.

The process disclosed in the '872 patent calls for preheating the chilled egg material to a temperature in the range

of approximately 90° to 130° F., until the fats therein are free-flowing, reducing the egg material to a state of fine dispersion by a homogenizer or equivalent device, so that the egg material is of a homogeneous character that does not exhibit any tendency toward separation of the fat particles from the egg solids, and then heating the fine dispersion to a pasteurizing temperature within the range of approximately 140° F. to approximately 165° F. The fine dispersion is held at the pasteurizing temperature for a period of time that is sufficient to kill or render substantially impotent all pathogenic organisms and undesirable bacteria.

The claims and specification of the '872 patent are not restricted to a process for treating whole eggs, but are capable of being interpreted to cover processes for products which contain ingredients in addition to whole eggs.

Turning now to the '487 patent, the patentees, in the specification thereof, stress the serious problems of spoilage and contamination by bacteria which exist in powdered, frozen and refrigerated bulk eggs. The specification also underscores how previous sterilization or pasteurization attempts directed at killing the bacteria have—

> * * * met with difficulty because when the eggs were heated to a temperature high enough to kill toxic and harmful bacteria, the eggs would partially coagulate or cook, rendering them unfit for most purposes. On the other hand, chemical sterilizing additives such as hydrogen peroxide, and additives such as sugars and starches, which raise the coagulation temperature, also render the eggs unfit for many purposes.

The patentees emphasize that their patented process overcomes these problems. They attribute the success of their process—

> * * * to a novel interrelation and cooperation between the homogenizing and pasteurizing steps permitting the use of higher pasteurizing temperatures with a closer approach to complete sterilization of the product than has been attainable heretofore in a uncooked product.

The necessity of having a three-step process, consisting of initially preheating the ingredients, then homogenizing the blend, and finally pasteurizing the blend at a predetermined

time/temperature relationship is explained by the patent to be:

> (1) In order to take maximum advantage of the phenomenon of oil envelopment of the egg solids * * * [the albumen and other egg proteins, particularly the chalazae, are allegedly able to withstand a higher temperature in the pasteurization step when they are coated in oil], it is preferred to pre-heat the mixture before the homogenizing step.
>
> (2) In the present process the homogenizing step precedes the final high temperature pasteurizing step. * * * By homogenizing before the final pasteurizing step, there is no possibility of coagulated chalazae strands getting into the homogenizer to clog its orifices. * * *
>
> * * * The protection of the albumen and other proteins by * * * [oil envelopment] appears to be far more effective when the egg material is reduced to an extremely fine dispersion than when the solids are merely beaten or mixed with oil in the absence of homogenization.
>
> (3) While the natural fats in the yolks themselves are effective, after homogenization, in allowing higher pasteurizing temperatures, it is still not possible to operate metallic surfaces at a sufficiently high temperature to produce a salmonella-free product. In the present processes the added oil augments the effect of the natural yolk fats to permit a sufficiently high plate temperature to produce a salmonella-free product without protein coagulation and without the material sticking to the plates. Conventional plate heaters may thus be used in all heating steps * * *.

As stated in the specification of the patents in suit, the crux of both inventions appears to be the discovery by the patentees that it is possible to pasteurize products containing eggs at temperatures sufficiently high to kill substantially all pathogenic bacteria (over 140° F.) without simultaneously denaturing or coagulating the egg protein. Further, the patentees stress that prior to pasteurization, the ingredients of the product being processed are to be preheated to a temperature which makes the fats free-flowing. The preheated ingredients are then reduced to a state of fine dispersion. An example of the type of apparatus which can be used

to create a fine dispersion is a positive displacement pump, such as a homogenizer.

Plaintiffs claim that as a result of the preheating step which makes the fats free-flowing, and the step of creating a fine dispersion, each protein strand becomes coated with a film of fat. Thus, plaintiffs' patents require that the fats be in a free-flowing condition prior to the creation of the fine dispersion. As a result of preheating and homogenization, the egg protein is covered by a layer of fat. This, in turn, makes it possible to heat the ingredients to a sufficiently high temperature to kill substantially all pathogenic bacteria without denaturing the egg protein. Plaintiffs emphasize that the fat layer surrounding the protein absorbs heat very rapidly so that the protein is thermally protected from the high temperature used to destroy the bacteria.

III. *Patent Claims Involved in Suit*

Plaintiffs urge that claim 1 of the '872 patent and all five claims of the '487 patent have been infringed by defendant during the 6 years immediately preceding the May 29, 1969, filing date of their petition. Claim 1 of the '872 patent reads:

> 1. The method of treating a shelled egg product without coagulating the same comprising
>
> pre-heating the egg product to a temperature within the range of approximately 90° F. to 130° F. until the fats therein are free-flowing,
>
> reducing the egg product to a state of fine dispersion,
>
> heating said dispersion to a pasteurizing temperature within the range from approximately 140° F. to 165° F., and
>
> holding the dispersion at said temperature to destroy substantially all pathogenic bacteria contained in the egg product.

The broadest claim in the '487 patent, claim 1, reads:

> 1. The method of preparing a salmonella-free homogenized and pasteurized egg product without coagulating the same comprising
>
> adding to natural shelled eggs a mixture of oil and milk solids in such amount that the end product has the ratio of total solids to total water plus solids

that is the same as the ratio of total solids of a natural egg to total solids and water in a natural egg, the oil being selected from the group comprising animal oil and vegetable oil, the total amount of the oil and milk solids being less than the weight of the natural shelled eggs,

mixing the natural shelled egg and the added material,

pre-heating the mixture to approximately 135° F. to make the natural fats in the natural shelled eggs free flowing,

reducing the mixture to a state of fine dispersion,

heating said dispersion to a pasteurization temperature of within the range of 150° F. to 170° F. by bringing the same into contact with the plates of a heat exchanger, and

holding the dispersion at said temperature to destroy substantially all of the pathogenic bacteria contained in the egg product.

Claim 4 of the '487 patent, the claim that was specifically referred to at trial, is somewhat narrower than claim 1, and reads as follows:

4. The method of preparing a salmonella-free homogenized and pasteurized egg product without coagulating the same, comprising

adding to natural shelled eggs a mixture of oil and milk solids in such amount that the end product is approximately 51.93% whole egg, 31.20% milk solids not fat, 15.27% oil and 1.6% salt, the oil being selected from the group comprising animal oil and vegetable oil, mixing the natural shelled egg and added material,

preheating the mixture to approximately 135° F. to make the natural fats in the natural shelled eggs free flowing,

reducing the mixture to a state of fine dispersion,

heating said dispersion to a pasteurizing temperature of within the range of 150° F. to 170° F. by bringing the same into contact with the plates of a heat exchanger, and

holding the dispersion at said temperature to destroy substantially all of the pathogenic bacteria contained in the egg product.

Finally, claim 5 of the '487 patent, which is the only product claim involved in the suit, reads as follows:

> 5. The product resulting from the process of claim 1.

IV. *Interpretation of the '872 Patent*

In *Motion Picture Patents Co.* v. *Universal Film Mfg. Co.*, 243 U.S. 502, 510 (1917), the Supreme Court stated that "The scope of every patent is limited to the invention described in the claims contained in it, read in the light of the specification." More recently, the Supreme Court reiterated that position in *United States* v. *Adams*, 383 U.S. 39, 49, 148 USPQ 479, 482 (1966), when it stated: "it is fundamental that claims are to be construed in the light of the specification and both are to be read with a view to ascertaining the invention." *See also*, *Tate Engineering, Inc.* v. *United States*, 201 Ct. Cl. 711, 719, 477 F. 2d 1336, 1340 (1973). Thus, a patentee is bound by his specification in interpreting his patent claims even when his specification requires a narrower interpretation of the claims than the patentee desires. *Texsteam Corp.* v. *Blanchard*, 352 F. 2d 983, 147 USPQ 431 (5th Cir. 1965), *cert. denied*, 387 U.S. 936 (1967).

In the present case, although the pasteurization step of claim 1 of the '872 patent in no way limits the manner in which it is to be carried out, the patent specification indicates that the maximum pasteurizing temperature is not to be achieved by contact of the egg product with hot metallic surfaces. Specifically, the patent, by way of the language found at column 3, lines, 33–44, clearly limits the way in which pasteurization is to be carried out, in the following manner:

> The present novel pasteurizing process rests upon the discovery that additives are not necessary to raise the coagulating temperature of albumen if the egg material is first reduced to a state of fine dispersion and the maximum pasteurizing temperature is not applied by hot metallic surfaces. When the egg material is reduced to a colloidal or homogenous state, it may be raised to a sufficient temperature for a sufficient time by a vaporous heating medium such as steam to kill or render substantially impotent all pathogenic organisms and undesir-

able bacteria without impairing the functional properties of any part of the egg material.

Further evidence of the patentees' concern that application of the pasteurization heat by hot metallic plate contact with the egg product would result in an alteration of the natural characteristics of the egg is found at column 9, lines 6–13, whereat is found:

> Leaving the homogenizer, the material is then heated to a temperature of approximately 143° F. in the plate heater section 26. The temperature here is held within the narrow range of approximately 140° to 144° F. to avoid any alteration of the natural characteristics of the egg material, or denaturation, by contact with the hot metallic plates, though actual coagulation would not start until a somewhat higher temperature was attained.

As a result of these statements in the specification, and in the interest of determining the true meaning of the claims, it is concluded that claim 1 of the '872 patent must be read as requiring that the maximum pasteurizing temperature not be applied by contacting the egg product with hot metallic surfaces. *See Autogiro Co. of America* v. *United States*, 181 Ct. Cl. 55, 63–64, 384 F. 2d 391, 397–98, 155 USPQ 697, 702–03 (1967), where this court indicated that the specification was to be looked to as the concordance for the claims.

Furthermore, this construction of claim 1 is required to distinguish it, as will be more fully discussed hereinafter, from the prior art and to thus avoid invalidity. *Calico Scallop Corp.* v. *Willis Bros., Inc.*, 458 F. 2d 390, 173 USPQ 321 (4th Cir. 1972); *Tate Engineering, Inc.* v. *United States*, *supra*.

V. *Interpretation of the '487 Patent*

The Supreme Court has stated that "* * * an invention is to be construed not only in light of the claims, but also with reference to the file wrapper or prosecution history in the Patent Office." *Graham* v. *John Deere Co.*, 383 U.S. 1, 33, 148 USPQ 459, 473 (1966). This direction has been followed by a number of courts, including: *Ellipse Corp.* v. *Ford Motor Co.*, 452 F. 2d 163, 171 USPQ 513 (7th Cir. 1971), *cert. denied*, 406 U.S. 948 (1972); *Waldon, Inc.* v. *Alexander Mfg. Co.*, 423 F. 2d 91, 165 USPQ 46 (5th Cir. 1970). Indeed, this

court's own pronouncement in *Autogiro Co. of America* v. *United States*, *supra*, at 63, 384 F. 2d at 397, 155 USPQ at 702, stresses that the claims of a patent are necessarily construed in connection with the other parts of the patent instrument, as well as the circumstances surrounding the prosecution of the patent application through the Patent Office.

In the present case, all of the claims of the '487 patent require a preheating of the egg mix to a temperature of approximately 135° F. The specification, at column 7, lines 8–10, indicates that a range of 125° to 140° F. satisfies this requirement, provided that the time interval during which the egg mix is exposed to the high end of the temperature range is not unduly prolonged.

However, not all of the originally-filed claims contained this temperature limitation. The examiner rejected the claims that failed to include such a limitation on the grounds that the process would not work for all preheating temperatures since it was critical to the invention that the fats be made free-flowing prior to homogenization by preheating the mix to a temperature sufficient to affect the free-flow of the fats. In particular, the application stated that a temperature range of 125° to 140° F. was required to ensure that the fats become free-flowing. Moreover, since the patent application gave no indication that acceptable results would be obtained if the preheat step was conducted at temperatures below 125° F., the claims were allowed only after the preheating temperature limitation was inserted. Limitations made in claims to gain allowance thereof are of the utmost importance and cannot be ignored in a later suit in favor of a broader claim scope. *Autogiro Co. of America* v. *United States*, *supra*, at 65, 384 F. 2d at 398–99, 155 USPQ at 703–04.

In addition, it should be noted that the '872 patent, which issued after the '487 patent but which was filed earlier, disclosed a preheating temperature range of 90° to 130° F. Of course, Eynon Jones is a named inventor in both the '872 and the '487 patents. Furthermore, the same patent attorney prepared and prosecuted both of the patents in suit through the Patent Office.

By way of explanation, plaintiffs during the trial stressed that because of the difference in formulation between the '487 egg mix patent and the '872 egg patent, a higher preheating temperature was needed to ensure that the fats of the ingredients of the '487 patent became free-flowing.

In view of the importance that both the Supreme Court and this court ascribe to the actions of a patentee during the prosecution of a patent application through the Patent Office, it must be concluded that at the time of filing the '487 patent application, the patentees deliberately selected 135° F. as the temperature for the preheating step in spite of the fact that a lower temperature range was being called for in the '872 patent application. Moreover, while the claims of the '487 patent specifically call for a preheating temperature of 135° F., the patent specification indicates that a temperature range of between 125° and 140° F. was intended to be covered by the claim limitation. It is equally clear that temperatures outside that range were not intended to be covered by the 135° F. temperature limitation.

Finally, it should be noted that all of the claims of the '487 patent require that the pasteurization temperature of between 150° and 170° F. be applied by bringing the fine dispersion formed by the homogenization step into contact with the plates of an ordinary milk-type pasteurizer.

VI. *Infringement*

In April 1960, Eynon Jones and two officers of Roberts Dairy Co. made their initial contact with the United States through the Quartermaster Food and Container Institute (hereinafter referred to as QMFCI) in Chicago. The QMFCI was at that time responsible for evaluating commercial food products for use in the military and for the development of new products, standards and specifications for military products.

During the years 1960 and 1961, defendant thoroughly tested plaintiffs' products which were made by the processes described in the patents and found them to be superior to the dry egg products then in use. Specifically, the tests showed that plaintiffs' egg products tasted better and had better shelf life than the egg products then in use.

The testing program led to the promulgation of a series of Government specifications which set forth the requirements that all products furnished thereunder had to meet. Because plaintiffs have structured their infringement case around the various specifications promulgated by defendant, it is necessary to review the pertinent parts of the relevant specifications to determine whether infringement is present. A summary of the pertinent parts of each specification and the infringement considerations relevant to each specification will now be made.

(1) *October 18, 1962, Military Specification*

This specification called for the following percentages of ingredients: whole egg solids—51%; milk solids, nonfat—30%; vegetable oil—15%; and salt—1.75%. Also, while the specification required blending of the above ingredients prior to homogenization, no indication was given that the ingredients had to be preheated prior to homogenization.

The pasteurizing step called for by the specification required that the blend be heated to about 150° F. or higher and held for not less than 2 minutes, and then heated to at least 165° F. and held for at least 2 seconds. The specification stated that steam infusion could be used to carry out the required pasteurization, but it did not require that it be used.

It is well established that a patent for a method or process is not infringed unless all steps or stages of the claimed process are utilized. *Engelhard Industries, Inc.* v. *Research Instrumental Corp.*, 324 F. 2d 347, 139 USPQ 179 (9th Cir. 1963), *cert. denied*, 377 U.S. 923 (1964). Thus, in order to find infringement in the present case, each and every step of each of the claims of the patents in suit, or an equivalent thereof, must have been practiced by the defendant.

Although it is possible that contractors producing egg products for defendant in accordance with the 1962 military specification could infringe plaintiffs' patents, acceptance by the United States of products made under that specification, without more, is insufficient to establish infringement of either patent. For example, this specification does not require preheating of the ingredients to about 135° F. prior to homogenization as is required by the '487 patent. Thus, for plaintiffs to prevail on their charge of in-

fringement of the '487 patent, it is necessary for plaintiffs to to prove that the egg product accepted by the United States was produced by a process that included preheating of the ingredients to 135° F.

Similarly, egg products made in accordance with the specification would not infringe plaintiffs' 872 patent unless it can also be demonstrated that the ingredients were preheated to between 90°–130° F. prior to being homogenized. Plaintiffs would also have to prove that the maximum pasteurizing temperature called for by the specification was not applied by hot metallic plates.

(2) *November 9, 1965, Military Specification*

The ingredients called for by this specification were the same as required under the 1962 military specification discussed in subsection (1) above. On the other hand, this military specification did require that the ingredients be mixed at a temperature between 100° and 135° F. prior to homogenization. Following homogenization, a pasteurization step similar in all respects to that called for by the 1962 military specification was required.

While products made in accordance with this specification could infringe both of the patents in suit, it does not follow that mere performance of the mandatory steps of the specification proves the defendant or its contractors have infringed either the '487 or the '872 patent.

In order to prove infringement of the '487 patent by performance under this specification, plaintiffs must show that preheating of the ingredients to about 135° F. occurred.

In order to prove infringement of the '872 patent by performance under this specification, plaintiffs must show that the maximum pasteurization temperature was not applied by using hot metallic plates.

(3) *PY–38—May 1968—United States Department of Agriculture Specification*

The ingredients to be used, and the percentages of each of the ingredients required by this specification were: whole egg solids—51%; milk solids, nonfat—30%; vegetable oil—15%; and salt—1.5%. While the specification did require that the ingredients be blended and thoroughly mixed prior to homogenization, there was no requirement that the blending and

mixing be done at any specific temperature. The specification also did not require that homogenization be accomplished at any particular temperature. It did, however, state that effective results were obtained by homogenization at a temperature between about 125° and 135° F.

Following completion of the homogenization step, the specification indicated that any one of the following three pasteurizing steps could be used: (1) the two-step 1962 military specification method, *see* subsection (1) above; (2) heating to 152° F. and holding for at least 2.5 minutes; or (3) heating to 150° F. and holding for at least 4.3 minutes.

While products made in accordance with this specification could infringe both patents in suit, it does not follow that a mere performance of the mandatory steps of the specification proves that defendant or its contractors have infringed either the '487 or the '872 patent.

For plaintiffs to prove infringement of the '487 patent by performance under this specification, plaintiffs must also show that the ingredients were preheated to 135° F. prior to being homogenized.

For plaintiffs to prove infringement of the '872 patent by performance under this specification, plaintiffs must also show that the ingredients were preheated to between 90°–130° F. prior to homogenization, and, as well, that the maximum pasteurization temperature was not applied by using hot metallic plates.

(4) *PY–45—March 1969—United States Department of Agriculture Specification*

This specification is exactly the same as PY–38, *see* subsection (3) above, except that the quantity of salt has been reduced to 1% from 1.5%. Accordingly, the proof required for plaintiffs to show infringement of either their '487 or '872 patent is the same as discussed in subsection (3) above.

(5) *PY–49—April 1970—United States Department of Agriculture Specification*

This specification is exactly the same as PY–45 except for the elimination of the statement that effective results were obtained by homogenizing the blended product at a temperature between about 125°–135° F. Accordingly, the proof required for plaintiffs to show infringement of either their

'487 or '872 patent is the same as discussed in subsection (3) above.

(6) *PY–53—December 1970—United States Department of Agriculture Specification*

This specification is exactly the same as PY–49.

A. *Monark/Mid-Central Infringement*

Since Mid-Central Egg Products, Inc., and Monark Egg Products, Inc., both produced egg mix for the Government using identical processes, plaintiffs' infringement charges against these companies will be jointly considered. Plaintiffs argue that the products produced by Monark and Mid-Central were made pursuant to United States Department of Agriculture (hereinafter referred to as USDA) specifications PY–38, PY–45, PY–49, and PY–53, and that by following all of the required portions of these four specifications, they have infringed the patents in suit.

The record establishes that the highest preheat temperature to which both Monark and Mid-Central subjected their mixes in performing under the above specifications was about 95° F. Following the preheat step, the mix was homogenized by passing it through a positive displacement pump. Finally, pasteurization was accomplished by heating the mix in excess of 152° F. for a time sufficient to kill substantially all of the pathogenic bacteria present in the mix. Pasteurization was accomplished by the use of an ordinary milk-type pasteurizer. The operation of an ordinary milk-type pasteurizer requires that the ingredients being pasteurized be heated to the desired temperature by contact with hot metallic plates.

Therefore, since the process used by Monark and Mid-Central to produce egg mixes in accordance with USDA specifications PY–38, PY–45, PY–49, and PY–53 utilized hot metallic plates to apply the maximum pasteurization temperature, the claims of the '872 patent are not infringed.

Furthermore, while the above-identified USDA specifications do not require that the ingredients be preheated, the testimony did establish that a preheat temperature of about 95° F. was used. However, since all of the claims of the '487 patent require a preheat temperature in the range of 125°–

140° F., infringement of the '487 patent has not been established.

Plaintiffs also urge that Monark's production under the 1965 military specification has resulted in the infringement of both of the patents in suit.

The testimony of record indicates that Monark on May 18 and June 30, 1966, was awarded contracts for the production of egg products in accordance with the 1965 military specification. The record also establishes that Monark followed all of the steps and requirements called for in the 1965 military specification in producing an egg product under each of the above-identified contracts. In accordance with the 1965 military specification, Monark preheated the ingredients to a temperature of between 100°–135° F. Homogenization of the preheated ingredients was effected by passing the product through a positive displacement pump. Lastly, pasteurization was accomplished by the steam infusion heating of the blend to about 150° F. or higher for not less than 2 minutes, followed by steam infusion heating to at least 165° F. for at least 2 seconds. Accordingly, the process used by Monark to manufacture an egg product which complied with the 1965 military specification did infringe claim 1 of the '872 patent.

However, no infringement of the '487 patent has been shown by Monark's production under the 1965 specification. The claims of the '487 patent require that the mixture be preheated to about 135° F. As explained above, the specification of the '487 patent teaches that a preheat temperature range of between 125°–140° F. satisfies the temperature requirements of the claims. While it is possible that Monark in manufacturing under the 1965 military specification preheated the ingredients to above 125° F., plaintiffs have not shown by a preponderance of the evidence that Monark preheated the ingredients to 125° F. Indeed, from the evidence of record it is just as likely that the preheat temperature did not reach 125° F., but was still within the 100°–135° F. range called for by the specification.

Plaintiffs have the burden of proving, by a preponderance of the evidence, that defendant has infringed their patents, *Stamicarbon, N.V.* v. *Escambia Chem. Corp.*, 430 F. 2d 920, 166 USPQ 362 (5th Cir.), *cert. denied*, 400 U.S. 944 (1970); *Safe Flight Instrument Corp* v. *McDonnell-Douglas Corp.*,

169 USPQ 328 (C.D. Calif. 1971), *aff'd*, 482 F. 2d 1086, 178 USPQ 13 (9th Cir. 1973), *cert. denied*, 414 U.S. 1113. Plaintiffs have not demonstrated either by the testimony or documents of record that the temperature to which Monark, in performing under the 1965 military specification, preheated the ingredients fell within the claimed range of the '487 patent. Accordingly, plaintiffs have failed to prove infringement of the '487 patent by production under the 1965 military specification.

While Mid-Central was never a licensee under either of the patents in suit, the record indicates that Monark did execute a license agreement with Roberts Dairy granting it a nonexclusive license under a number of different patents, including the two patents in suit. The Monark license agreement was executed on May 24, 1966, and expired on May 24, 1968. Moreover, the record indicates that royalties were paid by Monark to plaintiffs under this license agreement. On May 24, 1968, another license agreement, which had a 5-year term, was entered into by Roberts and Monark. This agreement had substantially the same terms and conditions as the earlier agreement.

It thus appears that all production by Monark after May 24, 1966, was done under license from plaintiffs. It is well established that suit against the United States in the Court of Claims under 28 U.S.C. § 1498 is proper only when the alleged infringement is accomplished by the United States, or a United States contractor, without a license to practice the invention. Accordingly, since Monark was licensed under the patents in suit for all production after May 24, 1966, plaintiffs' claim of infringement in the present forum is barred. Plaintiffs-licensors are barred from bringing a suit in this court even if Monark has failed to pay royalties to plaintiffs as required by their agreement. *Yassin* v. *United States*, 110 Ct. Cl. 211, 229, 76 F. Supp. 509, 520, 76 USPQ 466, 475 (1948); *Timken-Detroit Axle Co.* v. *Alma Motor Co.*, 144 F. 2d 714, 717, 62 USPQ 263, 266 (3d Cir. 1944), *rev'd on other grounds*, 329 U.S. 129, 71 USPQ 254 (1946); *Newport News Shipbuilding & Dry Dock Co.* v. *Isherwood*, 5 F. 2d 924, 934 (4th Cir.), *petition for cert. dismissed*, 269 U.S. 592 (1925).

It has been concluded hereinabove that production by Monark in accordance with the provisions of the May 18, 1966, contract does infringe the '872 patent. However, a review of that contract indicates that the egg product was not to be delivered to defendant until July 1966. This delivery date is, of course, after the execution of the May 24, 1966, license agreement between Monark and plaintiffs. Accordingly, while it is possible that the dehydrated egg mix was produced between the May 18, 1966, contract date and the May 24, 1966, license date, the record does not clearly indicate what the facts are on this point. Indeed, the contract delivery date indicates that, if anything, production occurred after the execution of the patent license agreement. In view of this, it must be concluded that plaintiffs have failed to show that infringement of the claims of the '872 patent took place before the license agreement was executed. Thus, no actionable infringement by Monark has taken place.

B. *SWEP*

Plaintiffs claim that SWEP has infringed the patents in suit by producing under Government specifications PY–38 and PY–45. The record indicates that the process used by SWEP to produce egg products for the Government under USDA specifications PY–38 and PY–45 began by mixing the required ingredients together at 45°–50° F. The ingredients were then preheated to a temperature in the 120°–130° F. range. The mix was then homogenized by passage through a positive displacement pump. Pasteurization at a temperature of about 151° F. for a time sufficient to kill substantially all of the pathogenic bacteria contained therein followed. The heating during pasteurization was accomplished by bringing the mix into contact with hot metallic plates.

Since the process used by SWEP to produce under the PY–38 and PY–45 specifications utilized hot metallic plates to apply the maximum pasteurization temperature, the '872 patent was not infringed.

However, since the process used to produce under these specifications did homogenize the 120° to 130° F. preheated

mix, and then pasteurize at a temperature of about 150° F., by bringing the mix into contact with the plates of a heat exchanger, the '487 patent was infringed.

C. *Harps*

Harps is accused of infringing the patents in suit by producing under USDA specifications PY–38, PY–45, PY–49, and PY–53. The record establishes that all of the steps called for by these specifications were followed by Harps in performing its contracts.

After the ingredients were mixed, the Harps' process called for their delivery, by centrifugal pumps, to a holding tank that was kept at a temperature of between 50° and 70° F. From this holding tank, another pump delivered the raw mix to a tubular heater, where the mix was preheated to a maximum of 87.5° F. A positive displacement pump, which acted as a homogenizer, transferred the mix to a pasteurizer. At the pasteurizer, the mix was heated to a temperature of about 154° F. for a time sufficient to kill substantially all of the pathogenic bacteria contained therein. Pasteurization heating was effected by bringing the mix into contact with hot metallic plates.

The specification of the '872 patent dictates that the pasteurization step of claim 1 be carried out by means other than bringing the mix into contact with hot metallic plates. Since the evidence shows that the process used to produce in accordance with USDA specifications utilized hot metallic plates to apply the maximum pasteurization temperature, the '872 patent was not infringed.

Moreover, since the Harps process used to produce under specifications PY–38, PY–45, PY–49, and PY–53 did not preheat the mix to a temperature greater than 87.5° F., the '487 patent, which calls for preheating to a temperature of about 135° F., was not infringed.

D. *Waldbaum*

Waldbaum is accused of infringing the patents in suit by producing under USDA specifications PY–38, PY–45, PY–49, and PY–53. All of the required portions of each of these

specifications were carried out by Waldbaum in producing egg products for the Government.

In producing egg products under all of the above USDA specifications, the highest preheating temperature to which Waldbaum subjected the ingredients was about 102° F. The preheat step was followed by the step of homogenization. Homogenization was accomplished by passing the preheated ingredients through a positive displacement pump or a dispersion pump. After homogenization, the mix was pasteurized. Pasteurization at a temperature of about 154° F. for a time sufficient to kill substantially all pathogenic bacteria present was accomplished by bringing the mix into contact with the hot metallic plates of an ordinary milk-type pasteurizer.

The specification of the '872 patent dictates that the pasteurization step of claim 1 be carried out by means other than bringing the mix into contact with hot metallic plates. Since the evidence shows that the process used to produce in accordance with specifications PY–38, PY–45, PY–49, and PY–53 utilized hot metallic plates to apply the maximum pasteurization temperature, the '872 patent was not infringed.

Moreover, since the Waldbaum process used to produce under USDA specifications PY–38, PY–45, PY–49, and PY–53 did not preheat the mix to a temperature greater than 102° F., the '487 patent, which calls for preheating to a temperature of about 135° F., was not infringed.

Waldbaum is also charged with infringing the patents in suit by producing egg products for the Government under the 1965 military specification. The record establishes that Waldbaum followed all of the required steps of the 1965 military specification in manufacturing egg products for the United States thereunder. In accordance with that specification, the ingredients were to be preheated to between 100° and 135° F. Thereafter, homogenization was effected by passing the mix through a positive displacement pump. Finally, through the use of a steam infusion method for pasteurization, the mix was heated to about 150° F. or higher for at least 2 minutes, and then heated to about 165° F. for at least 2 seconds.

The preheating of the ingredients to between 100° and 135° F., the homogenization of the preheated ingredients, and finally the pasteurization of the mix by steam infusion at the temperature called for by the 1965 military specification, establishes the infringement by Waldbaum of the '872 patent.

However, infringement of the '487 patent has not been established. Particularly, the evidence in the record indicates that Waldbaum on March 22, 1966, May 18, 1966, May 19, 1966, June 30, 1966, and July 28, 1966, was awarded contracts for the production of egg products in accordance with the 1965 military specification. That specification called for the ingredients to be preheated to between 100° and 135° F. The claims of the '487 patent, on the other hand, called for a preheating of the mixture to approximately 135° F. However, the specification of the '487 patent explains that a range of 125° to 140° F. is permitted for the preheating temperature.

While it is possible that Waldbaum, in carrying out the 1965 specification requirements, preheated the ingredients to above 125° F., the record does not establish the actual preheat temperature achieved. Therefore, it is just as likely that the preheat temperature did not reach 125° F., but was still within the 100°–135° F. range called for by the specification. Since, as hereinbefore discussed, with regard to plaintiffs' charges of infringement by Mid-Central/Monark, the burden of proof is on plaintiffs to demonstrate by a preponderance of the evidence that infringement took place, plaintiffs have failed to prove infringement of the '487 patent by production under the 1965 military specification.

On April 12, 1966, Waldbaum entered into a license agreement with Roberts Dairy whereby Waldbaum obtained a nonexclusive license under the two patents in suit. At the time of the agreement, Roberts had the power and authority to enter into this agreement. This agreement remained in effect until January 12, 1970, when Roberts terminated it. The sum of $2,000 was paid by Waldbaum to plaintiffs as a royalty under the license agreement. The royalty payment was made for the production of an egg product under a

process that called for the pasteurization step to be carried out by steam infusion.

The record clearly indicates that all infringing production by Waldbaum after April 12, 1966, was done under license from plaintiffs. As has been discussed in connection with plaintiffs' charges of infringement against Monark, a suit against the United States in the Court of Claims under 28 U.S.C. § 1498 is only appropriate when the alleged infringement is accomplished by the United States or a United States contractor who does not have a license to practice the invention. Therefore, the fact that Waldbaum was licensed under the patents in suit for all production after April 12, 1966, bars any claim for infringement in the present forum. No change in result occurs even if Waldbaum has failed to pay plaintiffs the agreed upon royalties for any period during which the contract remained in force. *See Newport News Shipbuilding & Dry Dock Co.* v. *Isherwood*, 5 F. 2d 924, 934 (4th Cir.), *petition for cert. dismissed*, 269 U.S. 592 (1925).

A review of the Waldbaum contracts that call for production under the 1965 military specification indicates that only the March 22, 1966, contract was entered into before Waldbaum became a licensee of plaintiffs. Of course, if Waldbaum produced the egg product called for by the March 22, 1966, contract before the April 12, 1966, license agreement, plaintiffs' charges of infringement would prevail, but the facts, however, appear to be to the contrary. Specifically, from a review of the March 22, 1966, contract it is noted that delivery was scheduled for July 1966. This delivery date is obviously long after the execution of the April 12, 1966, license agreement.

Accordingly, while it is possible that the dehydrated egg mix called for by the contract was produced between March 22, 1966, and the April 12, 1966, license date, the record does not clearly establish the facts on this point. Indeed, the contract delivery date indicates that, if anything, production occurred after the execution of the patent license. Therefore, plaintiffs have failed to establish by a preponderance of the evidence the existence of any actionable infringement by Waldbaum.

Plaintiffs claim that Marshall has infringed the patents in suit by producing dehydrated egg mix for defendant under USDA specifications PY–38, PY–45, PY–49, and PY–53. The record indicates that Marshall followed all of the required steps of each of these specifications in producing its egg products.

A first process used by Marshall for the production of egg mix included the step of mixing together eggs, which were at a temperature of about 40° to 50° F., oil, which was at room temperature, and milk, which was at a temperature of about 55° F. The mixed ingredients, whose combined temperature was in the range of 40° to 55° F., were then homogenized. The homogenized blend was then passed to a pasteurizer. The mix was heated by the pasteurizer to a temperature of about 155° F. by contact with hot metallic plates. The mix was held at that temperature for a time which was sufficient to kill substantially all of the mix's pathogenic bacteria.

In instances where larger quantities of egg mix were to be produced, the process was modified so that after the homogenization of the cold ingredients, described above, the blend was delivered by a pump to a preheater where its temperature was raised to between 85° and 90° F. The temperature range of 85° to 90° F. represents the maximum range to which the blend was preheated. After leaving the preheater, the blend was homogenized by a positive displacement pump and then sent to the pasteurizer. In the pasteurizer the blend was heated to about 155° F. by bringing it into contact with hot metallic plates, and kept at that temperature for a time sufficient to kill substantially all of the pathogenic bacteria contained therein.

As discussed hereinabove, the claims of the '872 patent are limited to pasteurizers which do not rely upon contact between the mix and hot metallic plates for the killing of substantially all pathogenic bacteria. On the other hand, the only evidence in the record indicates that Marshall followed the requirements of USDA specifications PY–38, PY–45, PY–49, and PY–53 and used a hot plate-type pasteurizer. It

is, accordingly, concluded that plaintiffs have failed to establish any actionable infringement of their '872 patent.

The claims of the '487 patent call for the ingredients to be preheated to a temperature within the range of approximately 135° F. The evidence establishes that Marshall, in producing dehydrated egg mix under USDA specifications PY–38, PY–45, PY–49, and PY–53, preheated the ingredients to a maximum temperature range of 85° to 90° F. Since the preheat range used in the Marshall process does not reach the 135° F. called for by the preheating step of the '487 patent, actual infringement under USDA specifications PY–38, PY–45, PY–49, and PY–53 has not been established.

Marshall is also accused of infringing the patents in suit by the manufacture of dehydrated egg products under the 1965 military specification in fulfilling an August 12, 1966, contract with defendant. The record establishes that on June 12, 1968, plaintiffs and Marshall executed an agreement granting Marshall a nonexclusive license under a number of patents, including the two involved in this action. The agreement was to expire on June 12, 1973. Moreover, by stipulation, plaintiffs have agreed not to seek payment from Marshall for any infringement that occurred prior to June 12, 1968. Accordingly, no liability attaches by virtue of Marshall's production pursuant to the August 12, 1966, contract, or for that matter, with respect to any production under USDA specifications PY–38, PY–45, PY–49, and PY–53, and/or the 1965 military specification.

F. *Pietrus*

Plaintiffs claim that Pietrus has infringed the patents in suit by producing dehydrated egg mix for defendant under USDA specifications PY–38, PY–45, PY–49, and PY–53. The record indicates that Pietrus performed all of the required steps of these specifications in producing egg mix for defendant.

In the Pietrus process, the ingredients were mixed together and then preheated. Although there was evidence to show that prior to March 8, 1968, these ingredients were preheated to a temperature within the range of 100° to 135° F., there was no evidence to indicate that subsequent to

that date the preheating temperature range was higher than 50°–63° F. The preheated mixture, after passing through a dispersion pump that affected homogenization, was sent to a pasteurizer. In the pasteurizer hot metallic plates contacted the mix and heated it to a temperature sufficient to kill substantially all of the pathogenic bacteria contained therein.

The '872 patent claims, as limited by the patent specification, require that pasteurization to kill substantially all pathogenic bacteria be done by an arrangement that does not require contact of the mix with hot metallic plates. However, since the processes used by Pietrus to produce egg mix under USDA specifications PY–38, PY–45, PY–49, and PY–53 all utilized hot metallic plate pasteurizers, no actionable infringement of the '872 patent by production under these specifications has been established by plaintiffs.

The record indicates that prior to March 8, 1968, Pietrus, in producing egg mix under specifications PY–38, PY–45, PY–49, and PY–53, did preheat the ingredients to a temperature within the range of 100°–135° F. The evidence falls short of establishing that Pietrus preheated the ingredients to a temperature range of 125° to 140° F., since it is just as likely that the ingredients were only preheated to a temperature within the range of 100°–120° F. Accordingly, since plaintiffs have the burden of proof on infringement, *see Stamicarbon, N.V.* v. *Escambia Chem. Corp.*, 430 F. 2d 920, 166 USPQ 362 (5th Cir.), *cert. denied*, 400 U.S. 944 (1970); *Safe Flight Instrument Corp.* v. *McDonnell-Douglas Corp.*, 169 USPQ 328 (C.D. Calif. 1971), *aff'd* 482 F. 2d 1086, 178 USPQ 13 (9th Cir. 1973), infringement of the '487 patent has not been established.

After March 8, 1968, Pietrus only preheated to a temperature range of 50°–63° F. Accordingly, no infringement of the '487 patent resulted from production under specifications PY–38, PY–45, PY–49, and PY–53.

Pietrus is also charged with infringement of the patents in suit by producing under the 1962 military specification with regard to contracts let on March 19, 1964, and April 14, 1965, and under the 1965 military specification with regard to four contracts let between March 22, 1966, and June 30,

1966. The testimony at trial established that Pietrus, in producing dehydrated egg mix under the contracts, followed all of the steps required by the appropriate specification.

We first turn our attention to plaintiffs' charge of infringement of their '487 and '872 patents by Pietrus' production under the 1962 military specification. Looking to the requirements of the 1962 military specification, it is noted that no preheat temperature is recommended. In the absence of a showing by plaintiffs as to what temperature was used by Pietrus, none can be assumed. Since plaintiffs have the burden of proof on infringement, no infringement of either the '487 or '872 patents, both of which require preheat temperatures of 90° or higher, has been established for production by Pietrus under the 1962 military specification.

We next turn to plaintiffs' charge of infringement for the egg products produced by Pietrus under the 1965 military specification. The testimony indicates that the preheating temperature used for production under the 1965 specification was about 120° F. However, the record also establishes that this preheat temperature was used for only a short period, and, as is explained in more detail in the findings of fact, only after the execution of a license agreement by plaintiffs and Pietrus.

The record also establishes that notwithstanding the requirement in the 1965 specification for use of a steam infusion-type pasteurizer, in fact, a hot plate pasteurizer was used. Accordingly, since the claims of the '872 patent, as limited by the patent specification, do not cover hot plate pasteurizers, no infringement of the '872 patent by Pietrus' production of egg products under the 1965 military specification has been established.

However, as mentioned above, the testimony does indicate that a preheat temperature of 120° F. was used in producing under the 1965 military specification. Further, there is no dispute that the mix was homogenized after preheating. Finally, the record also establishes that the Pietrus process used hot plate pasteurization at such a temperature to destroy substantially all pathogenic bacteria. Accordingly, infringement of the '487 patent has been established by Pietrus' production under the 1965 specification.

However, any infringement which did occur under the 1965 military specification is excused because of the existence of a license between plaintiffs and Pietrus. The testimony indicates that plaintiffs and Pietrus entered into a license agreement on March 8, 1966. The agreement granted Pietrus a nonexclusive license under a number of patents, including the two patents involved in this action. While it appears that the license was terminated on March 8, 1968, it was in existence during the time of the established infringement by Pietrus. Particularly, the four contracts, which called for production of an egg mix under the 1965 military specification, were entered into between March 22, 1966, and June 30, 1966. All production under these contracts was, accordingly, well within the March 8, 1966, and March 8, 1968, license period. As hereinabove discussed with regard to Mid-Central/Monark infringement as well as the Waldbaum infringement, the Court of Claims is not the proper forum for alleged infringement by the United States when the United States contractor is licensed by the patentee. Therefore, no liability whatsoever attaches to production by Pietrus.

VII. *Validity*

Defendant and the third-party defendants, in addition to their noninfringement defense, also contend that the two patents involved in this action are invalid. In support of their arguments on invalidity, defendant and the third-party defendants have cited a total of 34 prior art references. Reliance upon a multitude of prior art references in attempting to establish obviousness has often been found to buttress the statutory presumption of validity.[1] *Reynolds* v. *Whitin Mach. Works*, 167 F. 2d 78 (4th Cir. 1948), *cert. denied*, 334 U.S. 844. However, as will be discussed in considerable detail hereinbelow, the failure by the Patent Office to consider important prior art references while evaluating the patentability of a pending application has been found to be enough to overcome the statutory presumption of validity of an issued

[1] 35 U.S.C. § 282 provides in pertinent part:
"A patent shall be presumed valid. * * * The burden of establishing invalidity of a patent or any claim thereof shall rest on the party asserting it."

patent. *T. P. Laboratories* v. *Huge*, 371 F. 2d 231, 151 USPQ 605 (7th Cir. 1966).

After a careful review of the prior art references, it is concluded that no single reference discloses all of the steps required by the claims of the patents in suit. Therefore, neither the '487 nor the '872 patent are found to be invalid under 35 U.S.C. § 102 (1970).[2]

We next turn our attention to defendant's and third-party defendants' contentions that the '487 patent is invalid by reason of the failure of the claims thereof meeting the requirements for patentability set forth in 35 U.S.C. § 103 (1970).[3] While recognizing that the ultimate question of patent validity was one of law, the Supreme Court in *Graham* v. *John Deere Co.*, 383 U.S. 1, 148 USPQ 459 (1966), indicated that a factual analysis of the following factors was necessary in resolving the issue of patent validity under 35 U.S.C. § 103:

(1) the scope and content of the prior art;
(2) the difference between the prior art and the claims in issue; and
(3) the level of ordinary skill in the pertinent art.

In addition, secondary considerations, such as commercial success, satisfying a long-felt need, and failure of others are also relevant considerations.

With these guidelines in mind, it is pertinent to focus on the alleged purpose of the '487 invention. Specifically, it is noted that plaintiffs were directing their efforts toward satisfying an alleged need for a method for preparing a

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[2] 35 U.S.C. § 102 provides in pertinent part:

"A person shall be entitled to a patent unless—

"(a) the invention was known or used by others in this country, or patented or described in a printed publication in this or a foreign country, before the invention thereof by the applicant for patent, or

"(b) the invention was patented or described in a printed publication in this or a foreign country or in public use or on sale in this country, more than one year prior to the date of the application for patent in the United States, * * *."

[3] 35 U.S.C. § 103 provides:

"A patent may not be obtained though the invention is not identically disclosed or described as set forth in section 102 of this title, if the differences between the subject matter sought to be patented and the prior art are such that the subject matter as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which said subject matter pertains. Patentability shall not be negatived by the manner in which the invention was made."

salmonella-free homogenized, and pasteurized egg product which retains the taste and appearance of prepared fresh eggs.

The specifications of the patents involved in this action, *see* sections II, IV and V above for a more detailed discussion, particularly emphasize the importance of the interrelation and cooperation between the homogenizing and pasteurizing steps to permit higher pasteurization temperatures. Plaintiffs state that their process permitted the higher pasteurization temperatures without the coagulation of the albumen in egg whites and without the use of additives to raise the coagulation temperature of the albumen. Plaintiffs also urge that the inventions enabled egg whites to withstand higher pasteurizing temperatures without coagulation, by recognizing that a coating of oil over the egg protein separated the egg material from the hot pasteurizing surfaces. Plaintiffs, by way of their patent specifications, stressed that while some prior art processes utilized a homogenization step after pasteurization, in their processes the homogenization step preceded pasteurization. The homogenization step insured that the albumen and other egg proteins would be coated with oil prior to the commencement of the pasteurization step. In the words of the '487 patent:

> The protection of the albumen and other proteins by the oil appears to be far more effective when the egg material is reduced to an extremely fine dispersion than when the solids are merely beaten or mixed with oil in the absence of homogenization.

In explaining the necessity of plaintiffs' preheating step, the patent specification states:

> In order to take maximum advantage of the phenomenon of oil envelopment of the egg solids as hereinabove described, it is preferred to pre-heat the mixture before the homogenizing step. Egg yolks themselves contain a substantial percentage of natural fat which is available to act in the same manner as the added oil if the material is warmed to a degree sufficient to make the natural fats free flowing in the mixture. For this reason it is desirable to interpose the homogenizing step between a pre-heating step and the final pasteurizing step.

Opinion of Trial Judge

At trial, defendant and third-party defendants introduced a number of prior art references, only the following four are considered in this analysis:

(a) United States Letters Patent No. 2,479,310, which issued to Mr. Edward K. Chapin in 1949;

(b) An article by *Heller, et al.*, which appeared in FOOD MANUFACTURE, Vol. 33, Aug. 1958, pp. 335–37;

(c) Danish article by *Moller Madsen*, which appeared in SUNDHEDSPLEJEN, Vol. 10, No. 8, Dec. 1958, pp. 102–05; and

(d) Polish article by *Szczepula*, which appeared in PRZEMYSL SPOZYWCZY, Vol. XII, No. 1, March 17, 1958, pp. 21–26.

Except for the Chapin patent, which is cited in the '487 patent, none of the above articles were cited or considered by the Patent Office during the prosecution of the '487 or the '872 patents.

The Chapin patent relates to a process for producing and preserving powdered egg compositions. The Chapin composition is made up of various percentages of whole egg, milk solids and edible fat. Chapin requires that the liquid egg, milk and fat be rapidly added together and thoroughly mixed at a temperature which does not exceed 135° F. The mixture is then subjected to emulsification, to form a more stable oil-in-water emulsion and to finely subdivide the materials, by the use of mechanical means, such as a homogenizer or colloidal mill. Thereafter, the emulsion is spray dried to cause the evaporation of its moisture content and reduce it to a finely divided composite particle condition.

Chapin's powdered composition was not intended to be reconstituted for consumption as an egg product. Instead, Chapin intended and sought to produce a powdered, creamy, yellow, soft product which could be used directly in the preparation of baked products or for preparation of food mixes. Because the product would be subjected to high baking temperatures, pasteurization of the Chapin composition was not contemplated or necessary.

While the prior art Chapin patent does not teach the pasteurization of the powdered egg product, it does teach the first two steps of the claims of the '487 patent, *i.e.*, preheating and homogenization.

The Danish publication, SUNDHEDSPLEJEN, which was not considered by the Patent Office while either of the two patents involved in this action were pending as applications, describes the pasteurizing of egg products. After referring to the salmonella epidemics which occurred as a result of the increased use of industrially-treated egg products, the 1958 article stated that virtually all precautions taken to that date to ensure that egg products did not contain salmonella bacteria relied upon one form or another of heat treatment or pasteurization. According to the article, ordinary milk-pasteurizing apparatus has been the most common type of equipment used in the pasteurization of egg products.

The article, however, recognized, due to the variance in chemical composition, that different factors had to be considered in pasteurizing whole eggs, a mixture of egg white and egg yolk in the natural condition, pure egg yolks, or pure egg whites. Quite significantly, the Danish article also recognized that the destruction of salmonella was to be accaccomplished without at the same time cooking or otherwise affecting the appearance or quality of the final egg product. The article discusses in considerable detail the success achieved in pasteurizing whole eggs, egg yolks, and egg whites at temperatures as high as 68°–71° C. (154°–160° F.) by the use of a plate pasteurizer. Moreover, it significantly points out that whole eggs and egg yolks should be homogenized before pasteurization in order to obtain a product of uniform consistency.

We next consider the 1958 prior art article which appeared in FOOD MANUFACTURE. This article deals with a process used in Great Britain for the production of pasteurized frozen eggs. The process begins with the feeding of whole eggs, which have been previously filtered and chilled, to a homogenizer. Homogenization thus takes place, contrary to the teachings of plaintiffs' patents, at low temperatures. From the homogenizer, the homogenized egg is passed to a hot plate-type pasteurizer, of the type commonly used for pasteurization of milk, where it is held for a minimum of 2–5 minutes at temperatures of 144.5°–146° F. The article explains that no harmful effects appear to have been experienced by eggs that have been pasteurized at temperatures

below 160° F. After pasteurization, the egg product is cooled and transferred to a holding tank.

Finally, the March 17, 1958, Polish article also discusses the pasteurization of raw egg pulp. The article points out that in the years immediately following World War II, Poland utilized a long pasteurization time in its methods for processing raw egg pulp. Additives, such as trisodium citrate, were used to prevent the coagulation (cooking) of egg white during the long pasteurization periods. The use of additives permitted pasteurization at temperatures of 62°–63° C. (143.6°–145° F.) for about 20 minutes. However, there was concern that the process, which lasted about 3 hours and included the time needed to raise the temperature of the raw egg pulp to the pasteurization temperature as well as the time required to cool the product to 10° C. (50° F.), exposed the raw egg pulp to temperatures which were optimum for the development of many microbes and for activation of enzymes. In addition, the use of the trisodium citrate additive created a peculiar aftertaste in the final product.

The article went on to explain that as a result of the above deficiencies, a new short method for pasteurization of raw egg pulp was developed in Poland in 1952. The new process included the steps of:

> (1) breaking of eggshells, removal of contents and classification into three grades of acceptable eggs and refuse;
>
> (2) homogenization of the eggs and then passing the eggs to a cool container; and
>
> (3) forcing the egg pulp through a hot plate-type pasteurizer where it is exposed to temperatures of 10° C. (50° F.) to 67°–68° C. (153°–154° F.) and back to 10° C. (50° F.) in 3 to 6 minutes.

It should be noted that the Polish process does not include a step of preheating the eggs prior to homogenization. Nonetheless, the article, in commenting on the effectiveness of the process in killing salmonella, points out that no salmonella bacteria were found after examining 1,000 samples of an egg product that had been manufactured in accordance with the process.

All of the above-discussed prior art references are found to be highly pertinent and helpful in resolving the question of whether or not the inventions covered by the '487 and the '872 patents meet the nonobvious subject matter requirement of 35 U.S.C. § 103. It is noted that the '487 patent and the Chapin patent are concerned with the processing of an egg mix, whereas the '872 patent and the three prior art articles relate to the processing of whole eggs. Nonetheless, for reasons which follow, both of the patents in suit and the four prior art references are all found to pertain to the same art.

In the first place, it is noted that although over 50 percent of the process ingredients can be vegetable oil, milk and salt, the claims of the '487 patent identify the resulting product as an egg product. Moreover, perhaps in recognition of the standard which must be met before an article can be called an egg product, plaintiffs were careful not to permit the percentage of eggs in any of their egg mixes to drop below 50 percent. Lastly, it would have been natural for the plaintiffs to look to the egg art to solve any problems that they may have encountered in practicing their processes, because the most significant problem which they faced was coagulation or cooking of the egg during the pasteurizing step of their processes.

The prior art shows that at the time of the inventions in suit the general concepts of preparing an egg product by a process that included the steps of preheating, homogenization and pasteurization were well known. Particularly, the Chapin patent teaches a preheating step at a temperature not to exceed 135° F., and the creation of a fine dispersion by homogenization. While the step of pasteurization is not taught by Chapin, because his product was intended to be subjected to baking temperatures, he did recognize the beneficial effect to be gained by enveloping the egg solid with oil to prevent coagulation. Specifically, Chapin states:

> The added fat serves to preserve the egg component by insulating the delicate egg solids from induction of air during the steps of emulsification [homogenization] and subsequent dehydration and also tends to act as a buffer to prevent coagulation of the egg solids when the flash heat of the drying step is evaporating the moisture from the emulsion.

Moreover, pasteurization is taught by each of the three prior art articles discussed hereinabove. Indeed, the articles are quite explicit in teaching that salmonella bacteria in whole eggs can be killed by first homogenizing the whole egg and then heating the raw egg pulp, in hot plate-type pasteurizers, to a temperature of between 140°–160° F. for a few minutes.

It is thus clear that if at the time that the inventions involved in this suit were made, one wanted to make the Chapin product salmonella-free without at the same time coagulating the egg, it would have been within the skill of the art to use the pasteurization step taught by any of the three prior art articles because, as these articles explain, pasteurization to kill salmonella without coagulation is achievable providing that the whole eggs have been previously homogenized.

A review of the prior art is persuasive that plaintiffs, in making the invention defined by claims 1–5 of the '487 patent, did nothing more than combine well-known steps, in an obvious order, to obtain an egg product that one skilled in the art would expect. Therefore, claims 1–5 are invalid for failure to define a patentable invention within the meaning of 35 U.S.C. § 103.

For reasons discussed hereinabove with regard to the '487 patent, the '872 patent would also be found to be invalid under 35 U.S.C. § 103 if claim 1 thereof is broadly construed. However, as explained earlier in this opinion, the specification of the '872 patent requires that the pasteurization step called for by the claims be conducted by means other than hot metallic plate-type pasteurizers. The specification specifically speaks of the use of steam infusion-type pasteurization. Therefore, in line with this court's longstanding policy of favoring a construction of a patent claim that will render it valid over a construction that would render it invalid, *Tate Engineering, Inc.* v. *United States*, 201 Ct. Cl. 711, 477 F. 2d 1336 (1973), *Dominion Magnesium, Ltd.* v. *United States*, 162 Ct. Cl. 240, 320 F. 2d 388, 138 USPQ 306 (1963), the narrow construction hereinbefore explained is required for claim 1 of the '872 patent.

Conclusion of Law

None of the prior art cited by the defendant or the third-party defendants indicates that it would have been obvious to substitute a steam infusion pasteurizer for a hot plate-type pasteurizer. It must, accordingly, be concluded that, as narrowly construed, claim 1 of the '872 patent is not invalid under 35 U.S.C. § 103.

VIII. *Summary*

In summary, the following conclusions are made with respect to the issues of patent validity and infringement raised in this action:

(1) Production by Monark and Waldbaum of egg products for the United States under the provisions of the 1965 military specification infringes claim 1 of the '872 patent. However, a license from plaintiffs to both Monark and Waldbaum renders the plaintiffs' claim moot;

(2) Aside from (1) above, claim 1 of the '872 patent has not been infringed;

(3) Production by Pietrus of egg products for the United States under the provisions of the 1965 military specification infringes the '487 patent. However, a license between plaintiffs and Pietrus renders the plaintiffs' claim moot;

(4) Production by SWEP of egg products for the United States under USDA specifications PY–38 and PY–45 infringes the '487 patent;

(5) Aside from (3) and (4) above, the '487 patent has not been infringed;

(6) Claims 1–5 of the '487 patent are invalid under 35 U.S.C. § 103; and

(7) Claim 1 of the '872 patent is valid.

It is, therefore, concluded that plaintiffs are not entitled to recover, and that the petition should be dismissed.

CONCLUSION OF LAW

Upon the findings of fact, which are made a part of the judgment herein, the court concludes as a matter of law that plaintiffs are not entitled to recover and their petition is, therefore, dismissed.

Syllabus

530 F. 2d 896

LEESONA CORPORATION v. THE UNITED STATES

[No. 130-70. Decided January 28, 1976]

ON THE PROOFS

Patents; infringement; obviousness; implied license; reduction to practice.—Contending that seven of its patents have been infringed, plaintiff seeks reasonable and entire compensation for defendant's procurement of a mechanically rechargeable metal/air battery. Defendant has presented numerous defenses, attacking the validity of each patent on a multiplicity of grounds, asserting non-infringement of most of the patents, and alleging a license running to it under all of the patents. It is *held* that claims 4 and 7 of patent No. 3,419,900, claim 9 of patent No. 3,276,909, and claims 1, 2, 3, 5-8, 10, 16 and 17 of patent No. 3,436,270 are valid and infringed and defendant has no license thereunder; that claim 19 of patent No. 3,436,270, claims 1, 3, 4, 6 and 11 of patent No. 3,553,024, and claims 1, 3, 8 and 9 of patent No. 3,378,406 are invalid; that claims 12, 15 and 16 of patent No. 3,438,815 are not infringed by defendant; and that defendant is licensed under claims 1, 2, 3, 8 and 9 of patent No. 3,531,327. Plaintiff is entitled to recover reasonable and entire compensation in accordance with the opinion and judgment is entered for plaintiff therefor, the extent of which will be determined in further proceedings under Rule 131.

Patents; specifications; sufficiency of disclosure.

[1] A patent is directed to those skilled in the art and need only be in sufficient detail to enable them to practice the invention.

Patents ⇐ 118.9

Patents; anticipation; prior art or publication; generally.

[2] Where each and every term of a claim in a continuation-in-part application is supported and plainly disclosed in the parent application as originally filed and has been consistently presented, the claim is entitled to the filing date of the parent application, and a patent having a filing date subsequent to the filing date of said parent application is not a prior art reference against the claim.

Patents ⇐ 66(3), 90(1)

Patents; patentability; obviousness; generally.

[3] The defense of obviousness under 35 U.S.C. § 103 requires consideration of the scope and content of the prior art at the time the subject invention was made and a determination of whether the differences between that prior art and the claims in issue would have been obvious to one of ordinary skill in the pertinent art.

Patents ⇐ 18

Syllabus

Patents; patentability; substitution of materials.

[4] More than a mere substitution of materials is involved where a different material is used and the material is used in a different form to produce a different structure with significantly improved and unexpected results.

Patents ⇐ 21

Patents; patentability; obviousness; simultaneous invention by others.

[5] Simultaneous development by a number of individuals is sometimes considered an indicium of obviousness under 35 U.S.C. § 103.

Patents ⇐ 18

Patents; patentability; obviousness; delay and failure of others to produce invention.

[6] Nonobviousness of an invention is demonstrated by the fact that although the disclosed material was theretofore available, no one had suggested using it in the combination claimed, and after the subject invention became known virtually the entire industry shifted to its use although no one understood why the structure incorporating the material was superior in performance over the prior art.

Patents ⇐ 18

Patents; Court of Claims jurisdiction; employee of United States; co-inventor of continuation-in-part application.

[7] Although a co-inventor was an employee of the United States at the time he executed the continuation-in-part application on which the subject patent issued, since he was neither employed by nor in the service of the United States either when the claimed invention was made or when the original application was filed and since the claims in issue are entitled to the parent filing date, 28 U.S.C. § 1498 does not bar this suit.

Courts ⇐ 449(3)

Patents; title or ownership; license; implied license.

[8] Where plaintiff had incorporated Teflon-bonded electrodes in its own privately funded zinc/air battery program prior to its acquisition of the application which matured into the patent in suit, whose development was also financed by a private foundation, and where the Teflon-bonded electrodes of the patent claims were conceived and reduced to practice prior to plaintiff's contracts with the United States for militarization and procurement of plaintiff's battery, the Teflon-bonded electrodes were never a "subject invention" under the patent rights clauses of the contracts. While the batteries procured from plaintiff incorporated the Teflon-bonded electrode technology of the patent claims in issue, the Government contributed nothing to that development; moreover, through plaintiff's unilateral action in acquiring the said patent application any liability the Government may have had to the foundation by reason of the contracts with plaintiff was eliminated at no cost to

Syllabus

defendant. Having received benefits without expenditure of federal funds, and having failed to demonstrate any relationship between the early electrode development and the procurement of batteries, the Government is not entitled to a license under the patent.

United States ⇐ 97

Patents; patentability; obviousness; delay and failure of others to produce invention.

[9] Evidences of nonobviousness of the invention are the fact that orientation of the subject patented electrode was contrary to accepted practice in the art, and the fact that a large corporation in its extensive work in the same area failed to adopt a similar orientation until over 1½ years after the patentee and then found the good performance of the electrode to be surprising.

Patents ⇐ 18

Patents; defenses to suit; misrepresentation to Patent Office.

[10] While misstatements of fact in representations to the Patent Office may render a patent unenforceable, the general rule is that the misrepresentation must be relevant and material to the deliberations of the Patent Office. Where a misstatement was made in an affidavit regarding affiant's educational background but no factual errors were made in the substance of the test results set out in the affidavit, the misstatement was immaterial.

Patents ⇐ 97

Patents; title or ownership; license; implied license.

[11] Although the Navy had a contract with plaintiff involving work in the area of fuel cells and although the contract contained a patent rights clause and was still open at the time the subject invention relating to an electrode consisting of a polymeric film serving as a backing or support for a catalytic layer in a fuel cell was made, the Government does not have an implied license for use of such electrode because the electrode was neither conceived nor reduced to practice in performance of the work called for or required under the contract and the inventor's work was financed by in-house funds and did not pertain to any aspect of the particular work then being performed under the contract.

Patents ⇐ 210

Patents; infringement; identity of function or operation.

[12] More than a literal response to the terms of patent claims must be shown to make out a case of infringement. Where the accused device does not perform substantially the same function in substantially the same way for substantially the same purpose as the patented device there is no infringement.

Patents ⇐ 234

Patents; pleading and practice; validity/infringement issues; determination of.

[13] While the better practice in a suit for patent infringement is to treat both the validity and infringement issues, particularly in

view of the public interest in the validity issue, it is not always necessary to do so. Where non-infringement is clear and invalidity is not plainly evident, it is appropriate to treat only the infringement issue.

Patents ⇐ 314(2)

Patents; invention; abandonment; what constitutes.

[14] Plaintiff's contention that an invention was abandoned, suppressed or concealed, is negated where after operativeness of the device was demonstrated work thereon was continued, periodic reports were made, a patent application was filed promptly when the project was concluded, papers were published, and an attempt was made to sell the device.

Patents ⇐ 87

Patents; patentability; evidence of.

[15] The importance of the relationship of the replaceable anode and cathodes to the metal/air battery of the alleged infringed patent where none of the prior art either discloses the same relationship or achieves comparable results, is confirmed by the fact that it was copied in the accused batteries.

Patents ⇐ 36.1(2)

Patents; patentability; obviousness; delay and failure of others to produce invention.

[16] Non obviousness of a patented device is revealed by contemporaneous failure of others working in the same field to arrive at a similar construction.

Patents ⇐ 18

Patents; claims; construing and interpreting; generally.

[17] An interpretation of a claim to limit it to the disclosure of the specification is consistent with the principle that, where susceptible to more than one construction, that one will be adopted which will preserve to the patentee his actual invention.

Patents ⇐ 167(1)

Patents; title or ownership; license; implied license.

[18] Where the evidence demonstrates that the patented concept was conceived and reduced to practice by plaintiff prior to its entering into a contract with the Government, merely because plaintiff later used aspects of that technology in performance of the contract does not give the Government a royalty-free license under the patent.

Patents ⇐ 210
United States ⇐ 97

Patents; claims; method claim.

[19] It is generally the rule that patentability of a method claim must rest on the method steps recited, not on the structure used, unless that structure affects the method steps.

Patents ⇐ 101(11)

Per Curiam

Patents; patentability; new use or function; method.

[20] An old method of recharging a battery by replacement of an anode cannot be transformed into a patentably new one merely by using it to recharge a battery having a cathode not shown in the prior art. The validity of a purported new method must be assessed on the basis of the method steps described.

Patents ⇐ 27(1)

Patents; claims; define invention.

[21] The claims are the measure of the invention and validity must be determined not on the basis of an interpretation narrower than the language of the claims, but on the basis of what is claimed. It is not enough that a particular part shown in the drawings may be new and novel or may perform a new function; patent claims are required for the very purpose of forcing the patentee to insert in the claims those limitations and relationships regarded to be the invention.

Patents ⇐ 165(2)

Patents; double patenting; generally.

[22] Only one patent can be granted for one invention. Two patents directed to the same combination cannot be sustained where patentability of the claims in both is predicated on the same feature.

Patents ⇐ 120

Patents; reduction to practice; workability.

[23] Workability of an invention is a prime requirement for a reduction to practice.

Patents ⇐ 90(5)

Alfred W. Breiner, attorney of record, for plaintiff. *Robert F. Conrad* and *Breiner, Ramik & Brown*, of counsel.

A. David Spevack, with whom was *Assistant Attorney General Rex E. Lee*, for defendant. *W. Boswell Childs*, of counsel.

Before SKELTON, NICHOLS, and KASHIWA, *Judges*.

PER CURIAM: This case comes before the court on exceptions by the parties to the recommended decision filed February 27, 1975, by former Trial Judge Hal D. Cooper (since resigned), pursuant to Rule 134(h), having been considered on the briefs and oral argument of counsel. Since the court agrees with the trial judge's recommended decision, as hereinafter set forth, it hereby affirms and adopts the same as the basis for its judgment in this case. It is therefore concluded: (a) that claims re Patent No. 3,419,900 (claims 4 and 7),

Patent No. 3,276,909 (claim 9) and Patent No. 3,436,270 (claims 1, 2, 3, 5–8, 10, 16 and 17) are valid and infringed and defendant has no license thereunder; (b) claims re Patent No. 3,436,270 (claim 19), Patent No. 3,553,024 (claims 1, 3, 4, 6 and 11) and Patent No. 3,378,406 (claims 1, 3, 8 and 9) are invalid; (c) claims 12, 15 and 16 of Patent No. 3,438,815 are not infringed by defendant; and (d) defendant is licensed under claims 1, 2, 3, 8 and 9 of Patent No. 3,531,327. Accordingly, plaintiff is entitled to recover reasonable and entire compensation in accordance with this opinion and judgment is entered for plaintiff therefor, the extent of which will be determined in further proceedings pursuant to Rule 131.

OPINION OF TRIAL JUDGE

COOPER, *Trial Judge:* Contending that seven of its patents have been infringed, plaintiff seeks reasonable and entire compensation under 28 U.S.C. § 1498 for defendant's procurement of a metal/air battery designated the BB–626 ( )/U. Defendant presents its usual array of defenses, attacking validity of each patent on a multiplicity of grounds, asserting there is no infringement of most of the patents, and alleging a license running to defendant under all of the patents.

For the reasons hereinafter stated, it is concluded that the claims at issue in patents Nos. 3,276,909, 3,419,900, and 3,436,270 (except claim 19) are valid and infringed, and that defendant has no license thereunder. It is further concluded that the claims at issue in patents Nos. 3,553,024 and 3,378,406, and claim 19 in No. 3,436,270 are invalid; that patent No. 3,438,815 is not infringed; and that patent No. 3,531,327 is subject to a license to defendant.

The subject matter in this case pertains to batteries or, stated in more technical terms, electrochemical devices for producing electrical energy through chemical processes. These devices employ a pair of electrodes (an anode and a cathode), a fuel to be consumed, and an electrolyte as essential components in the production of electrical energy. In some batteries, flashlight batteries being but one example, all reactants, including the fuel which is a metal that is a

part of one of the electrodes, are contained in the battery package. In other more sophisticated types of batteries (sometimes called fuel cells),[1] the reactants, including the fuel which may be a gas such as hydrogen, are supplied continuously from an external source. In either case, it is the chemical process of fuel oxidation that produces the electrons for the current in an external circuit.

The fuel cell type of battery is usually distinguished from other batteries in that the fuel cell electrode is merely a situs for the chemical reaction and is not consumed by that reaction. As a result, the useful life of a fuel cell is not normally measured in terms of its electrode life. The more conventional batteries, on the other hand, are designed to have one or both of the electrodes take an active part in the reaction so that at least one of the electrodes is consumed by the reaction. When the electrode is consumed, either the battery is thrown away or it is electrically recharged. Historically, throwaway batteries have been known as "primary" batteries while the rechargeable type has been designated a "secondary" battery.

The metal/air batteries accused to infringe are a hybrid. As with conventional batteries, the anode of a metal/air battery contains the fuel and is consumed by the chemical reaction. The cathode, however, is not consumable and, as in a fuel cell, the reactant, oxygen, is supplied from the ambient air on a continuous basis. Further, although the battery is not electrically rechargeable and, hence, is of the primary type, it is designed for rapid mechanical replacement of the consumed electrode so it is considered to be *mechanically* rechargeable.

Of the patents in suit, the '909, '900, '815, and '024 patents are concerned with electrode structures. The '270, '406, and '327 patents are directed to a metal/air battery configuration and the mechanical rechargeability of that battery.

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[1] There is much confusion in the use of the terms "fuel cells" and "batteries." Battery is used, in a loose sense, as a name for a wide variety of different types of electrochemical devices. It is used to denote a plurality of cells, yet it is also used when referring to a single cell, *e.g.*, a flashlight "battery." Fuel cells are a part of the general "battery" field and a plurality of fuel cells are commonly referred to as a battery; however, the term "fuel cell" normally refers to a particular type of electrochemical device. (Findings 3, 4.)

Elmore and Tanner Patent No. 3,419,900

This patent discloses an electrode structure comprising a catalytic layer made from a uniform admixture of a fluorocarbon polymer and a catalytic metal powder. The fluorocarbon is preferably polytetrafluoroethylene (sometimes referred to either as PTFE or by du Pont's trademark Teflon). This mixture is carried by a suitable current collector such as a silver screen or a porous carbon block with the electrolyte being on one side of the catalytic layer and a gaseous reactant on the other.

Claim 4, the only independent claim asserted to be infringed,[2] is as follows:

> An electrochemical cell for the direct generation of electrical energy comprising an anode, a cathode, and an electrolyte, said electrochemical cell being constructed and arranged to provide a space between said anode and cathode and said space containing said electrolyte, at least one of said anode and cathode being a non-consumable, gas-consuming electrode comprising a catalytic layer containing a substantially uniform admixture of metal containing electrocatalyst particles and a fluorocarbon polymer, said catalytic layer being exposed to the electrolyte of the cell and having a porosity sufficient to permit diffusion of gases into said catalytic layer.

All of the elements of the claim are concededly old except for the use of "a substantially uniform admixture of metal containing electrocatalyst particles and a fluorocarbon polymer" as a catalytic layer. The evidence is that Elmore and Tanner were the first to use this combination of materials in an electrode for an electrochemical cell.

At the outset, defendant contends that the specification is defective within the meaning of 35 U.S.C. § 112 because it does not specify the critical ratio of the catalyst to the fluorocarbon. Although defendant is correct that precise recipes are not set out in the specification, a patent is directed to those skilled in the art and need only be in sufficient detail to enable them to practice the invention. *Trio Process Corp.* v. *L. Goldstein's Sons*, 461 F. 2d 66, 74 (3d Cir. 1972), *cert. denied*, 409 U.S. 997; *Gray Co.* v. *Spee-Flo Manufacturing*

[2] Claim 7, also asserted to be infringed, provides:
"The electrochemical cell of claim 4 wherein the fluorocarbon polymer is polytetrafluoroethylene."

Corp., 361 F. 2d 489, 493 (5th Cir. 1966). That requirement is satisfied here for it is clear from the evidence that a very wide range of ratios may be employed, depending on the particular desired use. The basic controlling consideration, as those in the art would readily recognize, is that an excess of polymer will adversely affect conductivity. As to specific ratios, the testimony of plaintiff's witnesses, Dr. Frysinger and Dr. Giner, and defendant's witnesses, Dr. Weissman and Mr. Moran, establishes that one of ordinary skill in the art would have no difficulty at all in selecting workable proportions in light of the patent disclosure.

Defendant next contends that the combination of claim 4 is anticipated by Niedrach et al Patent No. 3,297,484. This defense is premised on the contention that claim 4 is not entitled to the original filing date of March 4, 1960, but is entitled only to the December 22, 1966 date on which a continuation-in-part application was filed. Yet, each and every term of claim 4 is supported by, and was plainly disclosed in, the original application filed in 1960. Also from the time the first application was filed, Elmore and Tanner consistently presented claims to a new electrode composition consisting of a mixture of fluorocarbon and catalyst particles. In light of these facts, claim 4 is entitled to the filing date of March 4, 1960. *Pursche* v. *Atlas Scraper & Engineering Co.*, 300 F. 2d 467 (9th Cir. 1961), *cert. denied*, 371 U.S. 911 (1962); *Kollsman* v. *Ladd*, 226 F. Supp. 186 (D. D.C. 1964). Since the Niedrach patent has a filing date of May 8, 1961, it is not a reference against this claim.[3]

The principal defense asserted by defendant is that of obviousness under 35 U.S.C. § 103. This defense requires consideration of the scope and content of the prior art in 1958 when Elmore and Tanner made their invention, and a determination of whether the differences between that art and the claims in issue would have been obvious to one of ordinary skill in the art. *Graham* v. *John Deere Co.*, 383 U.S. 1 (1966).

Defendant relies mainly on Berl Patent No. 2,275,281, Winckler et al Patent No. 2,641,623, Witherspoon et al pub-

[3] Nor are any of the other patents that have filing dates subsequent to March 4, 1960.

lication entitled "*The Oxygen Electrode*,"[4] and the argument that the use of Teflon was a mere substitution of one plastic for another.

In considering this defense, it is necessary to place the prior art in context. Prior to 1958, a major problem with air- or gas-breathing electrodes had been the need to develop an electrode that would be permeable to the gas, but not so porous as to permit the electrolyte to flood the pores of the electrode. In the sophisticated fuel cell, a partial solution was the use of a biporous electrode structure and balanced gas pressures. In the more common variety of battery, various wet-proofing techniques were employed to control electrode flooding. Of particular interest are the approaches described in the Berl and Winckler patents, as well as in Witherspoon, wherein a binder material having hydrophobic properties is dissolved and the solution is combined with particles of a suitable material such as activated carbon. The generally accepted view is that the prior art approach, using, for example, ethyl cellulose, resulted in the electrode particles being at least partially coated with the plastic material. This material inhibits wetting of the electrode particles by the electrolyte and tends to form a barrier beyond which the electrolyte cannot pass. Since gas does not pass through liquid in significant quantities, this barrier then defines a line along which the chemical interaction among the three phases, gas, liquid, and solid, takes place.

The differences between the claimed electrode and that prior art, in terms of structure, reside both in the use of a fluorocarbon as the binder material and in mixing particles of the fluorocarbon with particles of catalyst instead of coating the catalytic particles with a solution of the plastic binder material as is the case with Berl and Winckler.

The differences between the claimed electrode and the prior art, in terms of functional operation, were the subject of extended testimony at trial. Dr. Giner's "flooded agglomerate" theory (finding 12) suggests that the claimed combination would allow the electrolyte to wet all of the catalyst particles, while the Teflon particles would provide a path

[4] The parties are in disagreement whether the Witherspoon et al publication is properly a reference. Since the claims are considered to be valid even if Witherspoon is a reference, it has been unnecessary to resolve that issue.

for the air to permeate the catalytic layer. This would permit the desired three-phase reaction to occur throughout the volume of catalytic material. Dr. Frysinger explained this as a "volume reaction" in which the entire volume of catalyst is utilized, as opposed to the "line reaction" of the prior art such as Berl and Winckler where the reaction takes place along a line defined by the gas-liquid interface.[5] Defendant s expert Dr. Gilman did not contest Dr. Giner's theory, but emphasized that it was only a theory; however, that theory has received acceptance in the industry and no opposing theories have been advanced.

The differences between the claimed electrode and the prior art, in terms of result, are not seriously in dispute. Teflon-bonded electrodes have demonstrated clear superiority in areas of energy and power density. Defendant's Dr. Gilman summed it up when he testified that everyone has gotten on the "bandwagon" of Teflon-bonded catalysts. This has included companies such as General Electric, American Cyanamid, and Pratt & Whitney.

Based on these differences in structure, function, and result, defendant's contention that the use of Teflon is a *mere* substitution of materials in the Berl and Winckler electrodes cannot be accepted. It ignores the fact that not only is the material not suggested by any prior art but that neither Berl nor Winckler suggests using binder particles in a mixture with catalyst particles. Thus, not only is a different material used, it is being used in a different form to produce a different structure, with significantly improved and unexpected results. Hence, more than a mere substitution is involved. *Carbide & Carbon Chemicals Corp.* v. *Coe*, 102 F. 2d 236, 241 (D.C. Cir. 1938); *Allen Filter Co.* v. *Star Metal Manufacturing Co.*, 40 F. 2d 252 (3d Cir. 1930), *cert. denied*, 282 U.S. 848.

Defendant also contends that Teflon-bonded electrodes were simultaneously developed by a number of individuals and that this is further indicative of its obviousness. While that factor is sometimes considered as an indicia of obviousness, see, *e.g.*, *Felburn* v. *New York Central R.R.*, 350 F. 2d

[5] Defendant's contention that the chemical reaction is the same irrespective of where it occurs is, of course, correct but entirely beside the point.

416, 425–26 (6th Cir. 1965), *cert. denied*, 383 U.S. 935 (1966), the facts do not support such a conclusion here. Elmore and Tanner made their invention in mid-1958, well over a year before the work of anyone else in the field. The bulk of the publications on which defendant relies to establish the alleged simultaneous invention bear dates subsequent to Elmore's public disclosure of their work in May 1960. Moreover, Elmore and Tanner have been recognized by those in the field as being the first to work with Teflon-bonded electrodes.

In the final analysis, the "before and after" actions and judgments of those in the field, *Safety Car Heating & Lighting Co.* v. *General Electric Co.*, 155 F. 2d 937, 939 (2d Cir. 1946), are the most persuasive evidence that the combination of claim 4 was an unobvious development. Before the invention, work was being done with plastic materials as binders for electrodes. Although Teflon was available, no one had suggested using that material, despite its well-known hydrophobic properties. After Teflon-bonded electrodes became known, virtually the entire industry shifted to it, even though no one understood why the electrode was so superior to the prior art. Since then, a great deal of research has been devoted to this electrode but, even now, only theories have been developed to explain its superior performance.

Under these circumstances, it is concluded that claims 4 and 7 are valid.

As to infringement, the BB–626( )/U is plainly an electrochemical cell for the direct generation of electrical energy. Defendant has stipulated that the cathode is a uniform admixture of Teflon and a catalyst. A case of infringement of claims 4 and 7 has been established.

Defendant's contention that 28 U.S.C. § 1498 bars this suit because Dr. Tanner was an employee of the United States at the time he executed the continuation-in-part application is without merit. Dr. Tanner was neither employed by nor in the service of defendant either when the invention of claims 4 and 7 was made in 1958 or when the original application was filed in 1960. Since the claims are entitled to the 1960 filing date, his subsequent employment history is irrelevant and the bar expressed in 28 U.S.C. § 1498 is inapplicable.

Finally, defendant contends that it is entitled to an "implied" license under this patent, pointing to a series of contracts commencing in March 1966 between the parties for the militarization and procurement of plaintiff's zinc/air battery, and to plaintiff's acquisition of the Elmore and Tanner patent application in June 1966. These facts, however, are insufficient to award defendant a license.

The Teflon-bonded electrodes of claims 4 and 7 were neither first conceived nor reduced to practice under any federally funded project, or under any contract with defendant. The work of Elmore and Tanner was financed by the Kettering Foundation, and plaintiff, which had been working with Teflon-bonded electrodes prior to 1966, had incorporated that type of electrode in its own privately funded zinc/air battery program prior to all of the contracts on which defendant relies. Therefore, Teflon-bonded electrodes were never a "subject invention" under the patent rights clause of any of the contracts, and as defendant apparently concedes, it has no express license.[6]

In view of these facts, defendant's reliance on the "close umbilical connection" doctrine of *Mine Safety Appliance Co.* v. *United States*, 176 Ct. Cl. 777, 364 F. 2d 385 (1966), is misplaced. In important aspects, the situation here is the reverse of that in *Mine Safety*. In that case, the court found that the contractor's allegedly separate project was in fact obtaining benefits from the Government sponsored and financed project being carried on at the same time. In this case, the benefits flow the other way. While the batteries it procured from plaintiff incorporated the Teflon-bonded electrode technology of claims 4 and 7, defendant contributed nothing at all to that development. Moreover, through plaintiff's unilateral action in acquiring the Elmore and Tanner application, any liability defendant may have had to the Kettering Foundation by reason of these contracts with plaintiff was eliminated, again at no cost to defendant. Having received those benefits without the expenditure of any federal

[6] Since, under defendant's contracts with plaintiff, Teflon-bonded electrodes were not a "subject invention," expressly licensed to the Government, this is not a situation where, by a subsequently acquired patent, the contractor attempts to dominate rights previously granted to the Government. *Compare, AMP, Inc.* v. *United States*, 182 Ct. Cl. 86, 389 F. 2d 448 (1968), *cert. denied*, 391 U.S. 964.

funds, and having failed to demonstrate any umbilical relationship between the work of Elmore and Tanner in 1958 and the procurement of batteries in 1966, defendant is not entitled to a license under this patent.[7]

Moos Patent No. 3,276,909

This patent discloses an electrode consisting of a polymeric film that serves as a backing or support for the catalytic layer. The patent suggests that either hydrophilic or hydrophobic polymers could be used, polytetrafluoroethylene being listed as one suitable polymer. If a hydrophilic material is selected, the patent specifies that it should be oriented so it is in contact with the electrolyte; if a hydrophobic material is used, the patent discloses it should be oriented so it is in contact with the gas.

Claim 9, the only claim at issue, provides:

> A fuel cell for the generation of electrical energy directly from a fuel and oxidant comprising an electrolyte, at least one oxidizing electrode, at least one fuel electrode, said electrodes being in contact with said electrolyte, and means for providing fuel cell reactants to said electrodes, ate [*sic*] least one of said electrodes comprising a porous hydrophobic polymer matrix having a porous conductive catalytically activating metal layer in intimate contact with one surface, the said catalytically activating metal layer being in contact with the electrolyte of the fuel cell.

The principal prior art on which defendant relies for its contention of obviousness is Williams Patent No. 3,116,170. That patent was also the principal prior art relied on by the Patent Office. It discloses a hydrophilic support for a catalytic layer oriented with the hydrophilic material in contact with the electrolyte. Claim 9 differs in that a hydrophobic material is specified and the orientation is the reverse of that shown in Williams.

In considering the unobviousness of these differences, *Graham* v. *John Deere*, *supra*, it is pertinent that Teflon-backed electrodes have now been widely adopted in the in-

[7] The suggestion that plaintiff reshaped the Elmore and Tanner application based on inputs from Government contract work is without any evidentiary support.

dustry and are recognized as one of the most efficient electrodes known. In light of the greatly improved performance of this type of electrode, two factors are particularly significant on the obviousness issue. As explained more fully in finding 19, the orientation of the Moos electrode was contrary to accepted practice in the art. This is evidence of nonobviousness. *United States* v. *Adams*, 383 U.S. 39 (1966). Moreover, General Electric, in its extensive work in this same area, failed to adopt a similar orientation until over 1½ years after Moos, and then found the good performance of the electrode to be surprising. (Finding 20.) That too is an indication of nonobviousness. *Jones Knitting Corp.* v. *Morgan*, 361 F. 2d 451, 457–8 (3d Cir. 1966).

The most pertinent prior art being that already considered by the Patent Office, and in view of the foregoing facts, it is concluded that claim 9 is valid.

Defendant also contends that the patent is unenforceable because, in an affidavit submitted to the Patent Office to distinguish the claim from the Williams reference, the inventor Moos stated that he holds a doctoral degree when, as plaintiff now stipulates, he does not. It is, of course, well settled that misstatements of fact in representations to the Patent Office may render the patent unenforceable. *Walker Process Equipment, Inc.* v. *Food Machinery & Chemical Corp.*, 382 U.S. 172 (1965). The general rule, however, is that the misrepresentation must be relevant and material to the deliberations of the Patent Office. *Tate Engineering, Inc.* v. *United States*, 201 Ct. Cl. 711, 477 F. 2d 1336 (1973); *Henkels & McCoy, Inc.* v. *Elkin*, 316 F. Supp. 303 (W.D. Pa. 1970), *aff'd* 455 F. 2d 936 (3d Cir. 1972). Here, the file wrapper history reveals that the purpose of the affidavit was to report the results of certain tests conducted in plaintiff's laboratory. The file history further indicates that it was the substance of the test results set out in the affidavit, not the degrees held by the affiant, that resulted in the allowance of claim 9. Since there was no factual error in the affidavit as to the tests conducted or the results thereof, the misstatement regarding Moos' educational background is deemed to be immaterial. Accordingly, the defense of unenforceability cannot be sustained.

Defendant also contends that claim 9 is not infringed. In large part, this is based on the assertion that a metal/air battery is not a "fuel cell." However, the Patent Office has stipulated to the contrary (findings 4, 21), and the evidence is that those in the art recognize this type of battery as a hybrid, having features of both a classic fuel cell and a conventional battery. The '909 patent is concerned with electrode structures and it is particularly in this area that those in the art have recognized the overlap between classic fuel cells and conventional batteries. Accordingly, the distinction defendant seeks to draw cannot be sustained.

Nor can the contention that the BB-626( )/U has no "means for providing fuel cell reactants" be accepted. The one reactant, air, is fed on a continuous basis through openings in the casing. The other reactant, zinc, is supplied on a batch basis each time an anode is replaced. While defendant is correct that the reactants in the embodiment disclosed in the specification are fed continuously, the claim language does not require this. Since a periodic batch replacement is clearly a means of supplying a reactant and since the particular means by which the reactants are fed was neither significant to the prosecution history nor to the invention itself, plaintiff is not limited to the specific mode disclosed. A case of infringement has been made out.

Finally, defendant contends it has an "implied" license under this patent, relying principally on a Navy contract it had with plaintiff involving work in the area of fuel cells.[8] Although that contract did contain a patent rights clause and was still open at the time Moos made his invention, the facts clearly show that the electrode was neither conceived nor reduced to practice in the performance of work called for or required under that contract. Moos' work was financed by in-house funds, and it did not pertain to any aspect of the particular work then being performed under that contract. Defendant has no license. *Erie Resistor Corp.* v. *United States*, 150 Ct. Cl. 490, 279 F. 2d 231 (1960).

[8] Although defendant also asserts a license under an Air Force contract, it has not identified any specific work performed by plaintiff that would give rise to a license as a result of that contract.

Giner Patent No. 3,438,815

This patent discloses an electrode which includes a micro-porous metal layer for controling bubble pressure, the pore size of the layer being about 1 to 50 microns in diameter.

Each of 12, 15, and 16, the only claims in issue, calls for a "porous self-sustaining metal layer of uniform and controlled porosity," this metal layer clearly referring to the micro-porous layer described in the specification. The accused battery has nothing of a similar nature. The current collector, specified by plaintiff as corresponding to the claimed metal layer, is a conventional expanded metal screen with openings far in excess of 50 microns. While it is porous and self-sustaining and, in a very loose sense, could be said to have a uniform and controlled porosity, it is clear that it is neither intended to perform the function of the micro-porous metal layer disclosed, nor in fact does so. Any effect it would have on bubble pressure would be incidental and entirely insignificant.

It is well settled that more than a literal response to the terms of the claims must be shown to make out a case of infringement. *Westinghouse* v. *Boyden Power Brake Co.*, 170 U.S. 537, 568 (1898); *Marvin Glass & Associates* v. *Sears Roebuck & Co.*, 448 F. 2d 60 (5th Cir. 1971); *Autogiro Co.* v. *United States*, 181 Ct. Cl. 55, 384 F. 2d 391 (1967), *rehearing denied*, 184 Ct. Cl. 801 (1968). Since the accused metal layer does not perform substantially the same function in substantially the same way for substantially the same purpose as the patented micro-porous metal layer, there is no infringement and, hence, there can be no liability under this patent. *Dominion Magnesium Ltd.* v. *United States*, 162 Ct. Cl. 240, 320 F. 2d 388 (1963).[9]

Fishman Patent No. 3,553,024

This patent discloses the same basic electrode structure as that in Moos Patent No. 3,276,909, differing only in the re-

[9] While the better practice is to treat both the validity and infringement issues, *Sinclair Co.* v. *Interchemical Corp.*, 325 U.S. 327 (1945), particularly in view of the public interest in the validity issue, *Ditto, Inc.* v. *Minnesota Mining & Manufacturing Co.*, 336 F. 2d 67 (8th Cir. 1964), it is not always necessary to do so. *Dresser Industries, Inc.* v. *United States*, 193 Ct. Cl. 140, 432 F. 2d 787 (1970). Where, as here, noninfringement is clear and invalidity is not plainly evident, it is appropriate to treat only the infringement issue. *Lockwood* v. *Langendorf United Bakeries, Inc.*, 324 F. 2d 82 (9th Cir. 1963).

quirement that the Teflon film is to be unsintered, *i.e.*, it has not been subjected to temperatures of 327° C. or above.

The difficulty in finding anything unobvious in the claimed combination is insurmountable. In suggesting the use of Teflon, the '909 patent does not distinguish between the sintered and unsintered types of films, but both types were available commercially in 1961 when the Moos patent application was filed. What is clearly taught by Moos, however, is that the Teflon is to be oriented toward the gas, thus requiring diffusion of the gas through the Teflon. In light of that teaching, and the known generally impermeable nature of sintered Teflon (finding 28), it is concluded that it would have been obvious to anyone with any skill at all at the time Fishman made his invention to try a permeable unsintered Teflon in the Moos arrangement. The substitution of an unsintered Teflon film in either of Examples 1 or 2 of the '909 patent would inherently achieve the advantages and benefits claimed by Fishman since none of the process steps in either of those examples would subject the Teflon to temperatures in excess of 327° C. Unsintered Teflon being the logical choice to use, there is nothing patentable in Fishman's selection of that material and claim 1 is deemed to define a combination that is obvious and invalid. *Mills* v. *Watson*, 223 F. 2d 335 (D.C. Cir. 1955).

Claims, 3, 4, and 6, dependent on claim 1, merely add details regarding the Teflon-bonded catalytic layer. Those details are disclosed in the '900 patent and add nothing of patentable significance to the combination of claim 1 when presented in this patent. Claim 11, also dependent on claim 1, merely describes a zinc anode, something notoriously old in the battery field.

Claims 1, 3, 4, 6, and 11 are invalid.

Oswin et al Patent No. 3,436,270

This patent discloses a metal/air battery having a gas permeable cathode of a particular design and a replaceable metal anode. The cathode, described as an envelope, forms a closely fitting pocket or enclosure for receiving the anode and the electrolyte. With this design, the cell is mechanically

recharged merely by removing the expended anode from the envelope cathode and inserting a fresh anode.

Claims 1, 2, 3, 5–8, 10, 16, and 17 (all article claims), and claim 19 (a method claim), are asserted to be infringed. Defendant does not contest infringement and it is clear that each of the claims is infringed.

Defendant relies on 11 patents, in various combinations, in support of its contention that the article claims are obvious. (Finding 30.) Of these, only the Heise and Thompson patents disclose a mechanically rechargeable concept. Thompson is not otherwise pertinent, being merely a classic type of railroad battery requiring a large volume of electrolyte. Heise does disclose a flat-cell configuration in which the anode is mechanically replaceable; however, the anode is spaced a substantial distance from the cathodes and this spacing, together with the rigid frame supporting the cathodes, both limits the intimate engagement of the anode, paste electrolyte, and cathode, and requires a substantial volume of the electrolyte. This same structural arrangement was basically employed by General Electric in its work in 1964.[10]

The contribution of Oswin and Chodosh lies in the close-fitting relationship of the replaceable anode and cathodes whereby a minimum volume of electrolyte is required and a high energy and power density cell is achieved. None of the prior art either discloses the same relationship or achieves comparable results. The importance of this relationship is confirmed both by the tests conducted by defendant (finding 32(b)) and by the fact it was copied in the accused batteries; its unobviousness is revealed by the contemporaneous failure of General Electric and Yardney to arrive at a similar construction. *LaSalle Street Press, Inc.* v. *McCormick & Henderson, Inc.*, 445 F. 2d 84, 93 (7th Cir. 1971).

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[10] See findings 31a–f. Contrary to plaintiff's contention, the General Electric work was not abandoned, suppressed or concealed. Its work in 1964, although it did not result in a battery of a character suitable for commercial use, was sufficient to demonstrate operativeness. Its continued work throughout the latter part of 1964 and early 1965, its periodic reports to its customer, the prompt filing of a patent application when the project was concluded, the subsequent papers it published, and its attempt to sell the battery to the Marine Corps, negate the contention that G.E. abandoned, suppressed or concealed the battery. *International Glass Co.* v. *United States*, 187 Ct. Cl. 376, 408 F. 2d 395 (1969).

Claim 1 [11] is cast in rather broad language but is specifically limited to an "envelope cathode." While language more specific in terms of structure would have been preferable, when construed in light of the specification and the prosecution history, it is apparent that this phrase was intended to describe a cathode structure that closely surrounds and encloses an anode. Clearly, the widely spaced cathodes and boxlike structures of Heise and General Electric are not an *envelope* in the sense intended by the patentees. Moreover, an interpretation of the claim which limits it to the close-fitting relationship disclosed in the specification is consistent with the principle that, where suspectible to more than one construction, that one will be adopted which will preserve to the patentee his actual invention. *Tate Engineering, Inc.* v. *United States, supra; Dominion Magnesium Ltd.* v. *United States, supra.* Here the construction most favorable in terms of preserving validity also coincides with the construction placed on the language by the patentees.

As properly construed, it is concluded that claim 1, and the claims dependent thereon, are valid and infringed.

Defendant's contention that it obtained a license under these claims by reason of work under an Air Force contract performed by plaintiff is unsupported by the facts. The evidence, largely exhibits introduced by defendant, is that the envelope cathode and mechanical-recharge concept were conceived and reduced to practice by plaintiff prior to its entering into the contract. (Findings 34a–e.) Merely because plaintiff later used aspects of that technology in the performance of its contract does not give defendant any rights under the patent. *Eastern Rotorcraft Corp.* v. *United States*, 181 Ct. Cl. 299, 384 F. 2d 429 (1967). Defendant received the benefit of that technology without paying for its development; it does not also get a royalty-free license.

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[11] Claim 1 is as follows:

"An improved metal-air or metal-oxygen electrochemical cell containing a gas permeable envelope cathode comprising a hydrophobic polymer membrane and a conductive catalytic coating on the inner surface of said membrane, a replaceable metal anode positioned within said envelope cathode, an electrolyte in the space separating the cathode and anode, and means for retaining said anode in said envelope cathode and permitting its ready removal."

As to method claim 19,[12] each of the recited method steps is inherent both in the Heise and the earlier G.E. work. The only distinction over the prior art lies in the envelope cathode structure set out in the claim. However, it is generally the rule that patentability of a method claim must rest on the method steps recited, not on the structure used, unless that structure affects the method steps. A. DELLER, PATENT CLAIMS § 372 (2d ed. 1971). In this case, it is apparent that the claimed method steps are not affected by the claimed cathode structure since the very same method would be used with the box cathode of Heise.

There can be no doubt that the invention of the '270 patent lies in the envelope cathode structure, not in the known method of recharging a battery by replacement of an anode. That old method cannot be transformed into a patentably new one merely by using it to recharge a battery having a cathode not shown in the prior art. *Pierce* v. *Muehleisen*, 226 F. 2d 200 (9th Cir. 1955); *Chenault* v. *Nebraska Farm Products, Inc.*, 138 F. Supp. 772 (D. Nebr. 1956). In short, claim 19 purports to define a new method and its validity must be assessed on the basis of the method steps described. Failing to define a method that is distinguishable from the prior art methods, claim 19 is held to be invalid.

Rosansky Patent No. 3,378,406

This patent discloses a metal/air battery of the same type and construction as disclosed in the '270 patent, Rosansky's contribution being a system of specially designed spacers that separate the adjacent cells to provide access of air to the cathodes.

The use of spacers to provide a flow path for a gas between adjacent electrode surfaces is notoriously old and those in the battery art were, long prior to Rosansky's work, familiar

[12] Claim 19:

"The method of generating electricity employing a metal/air or metal/oxygen electrochemical cell having a replaceable and consumable metal anode positioned within a gas permeable nonconsumable envelope cathode comprising a hydrophobic polymer membrane and a conductive catalyst layer on the inner surface of said membrane and an electrolyte separating said anode and cathode, said method comprising the steps of discharging said consumable metal anode by applying a load to said electrochemical cell, removing the discharged anode from said non-consumable [*sic*] envelope cathode and inserting a fresh or charged anode into said envelope cathode."

with the function of spacers in stacked electrodes. (Finding 36.) Plaintiff's contention that the particular spacers designed by Rosansky control the growth of the cell can be given no weight since it is much narrower than the language of the claims. The claims are the measure of the invention and validity must be determined on the basis of what is claimed. *Kemode Manufacturing Co.* v. *United States*, 171 Ct. Cl. 698, 347 F. 2d 315 (1965); *Chesterfield* v. *United States*, 141 Ct. Cl. 838, 159 F. Supp. 371 (1958). Claim 1 [13] merely calls for spacer elements; it does not relate those spacer elements to the cathode surfaces such that cell growth would be controlled. It is not enough that the particular spacers shown in the drawings may be new and novel or perform a new function. Patent claims are required for the very purpose of forcing the patentee to insert in the *claims* those limitations and relationships regarded to be the invention. *Strumskis* v. *United States*, 200 Ct. Cl. 668, 474 F. 2d 623, *cert. denied*, 414 U.S. 1067 (1973); *cf. Alma Motor Co.* v. *United States*, 133 Ct. Cl. 59, 134 F. Supp. 641 (1955).

By casting claim 1 in overly broad language, the patentee has simply failed to provide a structural bridge between the desirable functional results said to be achieved and the mechanism by which those results are obtained. As broadly claimed, the combination of a plurality of cells with spacers

[13] Claims 1, 3, 8, and 9 are in issue and provide as follows:

"1. An improved metal/air or metal/oxygen electrochemical battery comprising a plurality of electrochemical cells each containing an envelope cathode comprising a hydrophobic polymer membrane and a conductive catalytic layer on one major surface of said membrane, said one major surface comprising the inner surface of said cathode, a metal anode positioned within said envelope cathode, and an electrolyte in the space separating the cathode and anode, intercell spacer elements between adjacent cells, said spacer elements having openings therein to permit access of gaseous oxidant to said envelope cathodes, at least one of said spacer elements being arranged in said battery in such manner that said oxidant contacts at least one surface of at least two of said envelope cathodes only through the openings in said spacer elements."

* * * * *

"3. The improved battery of claim *1* including means for retaining said plurality of cells and said intercell spacer elements in operable structural association comprising an outer casing having openings therein to permit access of air or oxygen to the envelope cathode."

* * * * *

"8. The improved battery of claim *1* wherein the electrolyte of the electrochemical cell is trapped in a matrix."

"9. The improved battery of claim *8* wherein the metal anode is zinc, the hydrophobic polymer membrane of the envelope cathode is polytetrafluoroethylene, and an alkaline hydroxide electrolyte is trapped in a paper matrix."

therebetween does not distinguish from the G.E. battery or stacked cells of the Heise type.

While claim 1 is expressly limited to envelope cathodes, and defendant has not cited any prior art showing stacked envelope cathodes with spacers, that does not alter the obviousness conclusion. Plaintiff presents no argument that spacers, when used with envelope cathodes, achieve any different result or function any differently than when they are used with other kinds of cathodes. Most certainly, there is nothing in the claim to support such a conclusion. Accordingly, the question is simply whether the recitation of an "envelope cathode" in the combination of claim 1 is a sufficient basis on which to sustain the claim.

It is concluded that it is not. Only one patent can be granted for one invention. *Miller* v. *Eagle Manufacturing Co.*, 151 U.S. 186 (1894); *Tektronix, Inc.* v. *United States*, 195 Ct. Cl. 53, 445 F. 2d 323 (1971). Envelope cathodes were the invention of Oswin and Chodosh, not Rosansky, and their '270 patent discloses stacked envelope cathodes with spacers. Claim 2 of the '270 patent sets out the same basic combination of a plurality of stacked cells described in Rosansky's claim 1. Although not recited as a specific element, one practicing the combination of claim 2 would necessarily require spacers between the adjacent cells.

Plaintiff cannot proliferate its patent holdings merely by presenting claims which add to the basic envelope cathode arrangement of Oswin and Chodosh mechanical details such as spacers that, as broadly claimed, are obvious to those in the art. *Cf. Pratt & Whitney Co.* v. *United States*, 170 Ct. Cl. 829, 345 F. 2d 838 (1965). In other words, two patents directed to the same combination cannot be sustained where patentability of the claims in both is predicated on the same feature. Since the '270 patent covers the basic envelope cathode invention, and Rosansky's work only purports to be an improvement thereof, it is claim 1 that must fall. *In re Stanley*, 214 F. 2d 151 (CCPA 1954); *cf. In re Vogel*, 422 F. 2d 438 (CCPA 1970).

Claim 3 merely adds a battery case having openings. Packaging of cells in a case is notoriously well known, as shown for example in the Hollman et al patent (finding 36) wherein

the case holds the cells in an assembled relationship. Merely providing openings in the case for allowing air to reach an air-breathing electrode, which is all the claim requires, is an obvious concept.

Claims 8 and 9 add only details regarding the electrolyte and the Teflon backing of the electrode. These features were not the invention of Rosansky and were, at the time of his work, known in the art. They add nothing of patentable significance to the combination of claim 1.

Claims 1, 3, 8, and 9 are held to be invalid.

Moos Patent No. 3,531,327

This patent discloses a gas and liquid impermeable package containing a consumable metal anode, a separator material around the anode, and all of the electrolyte material needed to operate a metal/air cell over the life of the metal anode. This method of packaging the anode permits mechanical recharging of the metal/air cell of the '270 patent without the need for bottles of corrosive electrolyte material.

Defendant does not seriously assert noninfringement but attacks validity, as well as contends for a license. Because of the conclusion that the license defense is a sound one, it is unnecessary to consider the issue of validity.[14]

Plaintiff developed the mechanical-recharging concept under its own in-house program and, by September 1965, had commenced packaging anode-electrolyte composites in polyethylene bags to test their shelf life. These shelf-life tests continued at a low level of activity until April 1966 when a comprehensive program to investigate the parameters affecting shelf life of packaged anodes was commenced. Up to that time, all of the packaging had been with polyethylene. Commencing in the early part of 1966, plaintiff entered into a series of contracts with defendant regarding the supply of mechanically rechargeable metal/air batteries. The packaging of anodes was part of the work under these contracts. Plaintiff continued its evaluation and work on packaging of anodes until October 1967, by which time it was determined that polyethylene was unsatisfactory due to its permeability. A composite of Mylar, polyethylene, and aluminum foil was then used to package the anodes.

[14] See n. 9, *supra*.

The nature of the '327 invention is such that its workability, a prime requirement for a reduction to practice, *Eastern Rotorcraft Corp.* v. *United States*, *supra*, could not be ascertained until after the packaged anode-electrolyte composite had been subjected to suitable shelf-life tests. Those tests revealed that the polyethylene was unworkable because it did not provide a substantially liquid impermeable envelope. Since claim 1 expressly requires a liquid impermeable envelope, and since that limitation is of critical importance to achieving the objectives of the invention, it is apparent that there was no reduction to practice of the invention through use of the polyethylene. A workable material satisfactorily meeting the requirements of claim 1 was not found until 1967, at the time and during the course of work under contracts with defendant. (Findings 38, 39.)

The standard patent rights provision contained in plaintiff's contracts gives defendant a license under any invention "first actually reduced to practice" in the course of the contract. In view of the foregoing facts, it is clear that defendant has a license under the combination of claim 1, as well as dependent claims 2, 3, 8, and 9.

Addendum

Because of the number of patents involved and the need to treat each patent individually, a few matters that either could not or should not be so compartmentalized remain to be mentioned.

While it is difficult to assess, on an individual basis, the relative contributions of the inventions of the '900, '909, and '270 patents to the success of the BB–626( )/U, there is no doubt that they were of substantial importance. In head-on competition with the conventional silver/zinc battery, the BB–626 proved to be superior beyond any question. (Finding 40(c).) For example, the conventional battery required 10 hours to recharge while plaintiff's battery requires only 10 *minutes*. It proved to be lighter, with greater capacity and higher power levels. This superiority was in large part due to the Teflon-bonded electrode (covered by the '900 patent), the Teflon backing of the electrode (covered by the '909 patent), and the envelope configuration of the cathode and its

mechanical rechargeability (covered by the '270 patent). This is further evidence of the validity of these patents.

On the license issue, defendant has two arguments that have not been mentioned. The first is that the whole history of the dealings between the parties leads to the conclusion that it was the mutual effort of both plaintiff and defendant that led to the creation of the accused devices. A review of that history, however, rather readily reveals that this argument is not supported by the facts and must be rejected. Basically, the contracts between the parties fall into two categories, one for work on fuel cells and the second relating to metal/air batteries. The fuel-cell work was performed in the late 1950's and early 1960's and was related to Bacon-type cells with biporous nickel electrodes.[15] The technology of biporous nickel electrodes is a separate subject and quite unrelated to the Teflon bonded-and-backed electrodes here in issue. The parties did not have any dealings on metal/air batteries until mid-1965, at the earliest. By then, plaintiff already had developed, tested, and demonstrated, with its own funds, the basic zinc/air battery that became the BB–626.

In sum, plaintiff's work on Bacon cells did not generate, nor was it related in any way to, the inventions here in issue while the metal/air contracts were after the fact and dealt only with militarization and procurement of the batteries. To the extent patentable innovations were made under these latter contracts, defendant has already received express licenses from plaintiff (finding 42).

This leads to the second of defendant's points which is that, because it is expressly licensed under certain patents covering improvements made by plaintiff during the course of militarizing the battery, it argues it should receive a license to practice the inventions in plaintiff's basic patents. This contention has no substance, particularly in light of the express language in the contract documents which limits defendant's rights to "subject inventions" made under the contract, and the language of the express license agreements

[15] Previous to these contracts, plaintiff had acquired the rights to the Bacon technology which, in the early 1960's, had the highest theoretical current density of any known fuel cell.

which states that the Government shall not obtain a license "by implication or otherwise" to any inventions other than those expressly licensed. *Eastern Rotorcraft Corp* v. *United States*, *supra*; *Erie Resistor Corp.* v. *United States*, *supra*.

FINDINGS OF FACT

1. Plaintiff is a Massachusetts corporation having its principal place of business at Warwick, Rhode Island. Accused to infringe the seven patents in suit is a mechanically rechargeable metal/air battery (designated the BB–626 ( )/U), procured from the Eagle-Picher Company. Plaintiff has been record owner of the patents, identified below, since their respective dates of issuance:

Patent No.	*Subject Title*	*Inventors*	*Claims in Suit*
3,419,900.	Fuel Cells With Alkali Metal Hydroxide Electrolyte And Electrode Containing Fluorocarbon Polymer.	G. V. Elmore & H. A. Tanner.	Claims 4 & 7.
3,276,909.	Fuel Cell Electrodes	A. M. Moos	Claim 9.
3,553,024.	Electrochemical Device Utilizing An Electrode Comprising A Continuous PTFE Film Which Is Gas Permeable And Free From Liquid Electrolyte Seepage.	J. H. Fishman	Claims 1, 3, 4, 6, & 11.
3,438,815.	Electrochemical Cell Containing An Electrode Comprising A Catalytic Layer Consisting Of Uniformly Dispersed Catalytic Metal Particles And A Hydrophobic Polymer, And (In Contact With The Cell Electrolyte) A Separate Porous Metal Layer.	J. D. Giner	Claims 12, 15, & 16.
3,436,270.	Oxygen Depolarized Cell And Method Of Producing Electricity Therewith.	H. G. Oswin & S. M. Chodosh.	Claims 1, 2, 3, 5, 6, 7, 8, 10, 16, 17, & 19.
3,531,327.	Metal/Air Batteries	A. M. Moos	Claims 1, 2, 3, 8, & 9.
3,378,406.	Metal-Oxygen-Containing Electrochemical Battery.	M. G. Rosansky	Claims 1, 3, 8, & 9.

Background

2. The technology is electrochemical devices for the generation of electrical energy by chemical processes, such devices being commonly referred to as batteries or cells. Historically, batteries have been classified as either primary (not rechargeable) or secondary (electrically rechargeable). Both classes employ a cathode, an anode, and an electrolyte, and the basic chemical process is one of oxidation of a fuel at the anode, with the electrons from the oxidized material being transferred via an external circuit to an oxidizing agent at the cathode, which is reduced. The reactant at the cathode is often referred to as the "depolarizer." A typical dry cell

may use, for example, zinc as the anode, manganese dioxide as the cathode, and ammonium chloride as the electrolyte.

3. The term "fuel cell" also refers to a cell in which electrical energy is derived from the oxidation of a fuel. Classically, both electrodes in a fuel cell are invariant, gaseous reactants are continuously fed to both electrodes, and ancillary equipment is utilized to control various operating conditions including the temperature and pressure of the cell, electrolyte circulation, and by-product removal. It is conventional practice to use catalysts in these devices. Fuel cells have always been understood by those in the art to be an electromechanical device for the generation of electrical energy by chemical processes and are considered to be a part of the battery field.

An example of a fuel cell is the Bacon cell (see, *e.g.*, U.S. Patent No. 2,969,315) which utilizes hydrogen as the fuel, oxygen as the oxidant, and porous nickel electrodes. This cell will typically operate at over 200° C. and at elevated pressures with very high current densities.

4. Some batteries or cells possess characteristics of both a classical fuel cell and a conventional battery. An example is the metal/air battery in which a metal, for example, zinc, is used as the anode and provides the fuel to be oxidized while oxygen in the air is used as the oxidizing agent to be reduced at the cathode. The zinc anode is consumable and comprises a finite supply of fuel, while the cathode is invariant and air is supplied to it on a continuous basis. A catalytically active material is usually used at the cathode to accelerate the reaction process. The battery operates at ambient pressure and temperature. In *Leesona Corp.* v. *Commissioner of Patents*, Civil Action No. 1537–69, the Patent Office stipulated that a metal/air battery is a simple fuel cell, in that it is self-contained, requires no ancillary equipment, and is operable on air at ambient temperatures and atmospheric pressures. Those in the art consider a metal/air battery to be a hybrid type of fuel cell and a plurality of fuel cells are commonly referred to as a battery. Defendant's employees sometimes refer to these as metal/air fuel cells.

5. One of the early metal/air batteries was an alkaline air-depolarized zinc system, exemplified by a railroad bat-

tery, employing a carbon cathode, a zinc anode, and a caustic electrolyte. Examples are found in United States Patents Nos. 2,044,923, 2,097,077, 2,275,281, and 2,863,769, and in PX–73 and 74. The capacity of this type of battery is limited by the quantity of electrolyte present. In general, no air-depolarized batteries or cells available prior to 1965 were capable of high current drains or of sustaining a high energy-density ratio. A major problem with the air-depolarizing battery was the need for a suitable porous carbon electrode that would contact the electrolyte, yet allow atmospheric oxygen access to the carbon surface. If the electrode was too porous, the electrolyte would flood the pores and prevent access of the gas to the electrode. This problem was partially solved by a wet-proofing treatment whereby the electrode surface was coated with a material to render it hydrophobic, *i.e.*, water repellant to some degree. This treatment allowed the electrolyte to penetrate the electrode only to a limited extent, thereby allowing the air to pass through the unwetted portion of the electrode. The desired chemical reaction then took place along the line where the air and electrolyte met in the carbon electrode.

6. Various wet-proofing treatments of electrodes have been developed. By the early 1950's, electrodes were being treated by impregnation with wax, grease, rubber, or other water-repellant substances to render the electrode substantially impervious to the electrolyte. U.S. Patents Nos. 1,544,030, 1,588,607, 2,017,280, and 2,938,064 are illustrative of these techniques. Powdered materials were also treated with a suitable substance, repellant to liquids, and then formed into electrodes, as disclosed, for example, in U.S. Patents Nos. 1,588,607 and 2,641,623. Typically, the substance was used in solution and was intended to coat the powder particles.

7. The problem of maintaining a porous, unflooded, carbon electrode also confronted those working on fuel cells. In a fuel cell, porous electrodes are necessary to permit the reacting gases to pass through the electrodes to the site of the electrochemical reactions at the solution-electrode interface. The wet-proofing treatment used in batteries was also used in fuel cells, particularly those using porous carbon electrodes, but other techniques were developed. Bacon's

H_2–O_2 cell employed a biporous nickel electrode, consisting of a relatively coarse pore structure for most of the electrode thickness, and a thin, fine pore structure on the electrode side facing the electrolyte. This was found to provide a relatively stable liquid-gas interface in the region where the coarse and fine pore layers joined; however, it was necessary to maintain a controlled pressure in the gas-phase side of each electrode so that the gas would satisfactorily penetrate the electrode, but would not bubble through and form an explosive gaseous mixture.

Patent No. 3,419,900

8. (a) In 1958, as a part of a continuing interest in energy storage and conversion, the Kettering Foundation, Yellow Springs, Ohio, commenced an investigation into fuel cells. A principal objective of the investigation was the development of a fuel cell that could be operated at atmospheric pressure and at moderate temperatures, *i.e.*, 100° C. to 200° C. This objective required the development of both a suitable electrolyte and a porous electrode of good electrical and electrochemical properties. Dr. Howard A. Tanner, Director of Research, and Glenn B. Elmore, a chemist, were involved in this program. The problem of waterlogged or flooded electrodes, particularly where hydrogen-containing materials were used, was known to Elmore and Tanner. They were also aware of prior waterproofing techniques using materials such as kerosene and wax.

(b) During the course of their work, Elmore and Tanner developed essentially three types of electrodes. The first (shown in Fig. 1 of the '900 patent) had a catalyst mixed with a colloidal dispersion of a fluorocarbon, polytetrafluoroethylene (du Pont's Teflon), pasted on a screen. The second (shown in Fig. 2) used a porous carbon block treated with Teflon and then a catalyst-Teflon mixture was pasted on the block. The third consisted of a porous carbon block electroplated with the metal catalyst followed by a wetproofing treatment with Teflon. Current densities obtained with the third electrode were only about half that achieved with the other two. By the fall of 1958, Elmore and Tanner had a working fuel cell having an electrode comprising an admixture of Teflon and electrocatalyst satisfactorily

operating both at room temperature and at elevated temperatures.

(c) At the conclusion of their investigation, it was the opinion of Elmore and Tanner that they had developed a new type of porous electrode capable of achieving higher current densities over a prolonged period than had theretofore been obtained. They were well aware in 1958 that the improved porous electrode was usable in an electrochemical cell in which it was necessary to achieve a three-phase reaction of gas, liquid, and solid. Their interest being primarily in the H_2—O_2 type of fuel cell, it was in that context that their application was presented to the Patent Office. It was also in that context that they first publicly disclosed their work, first in an oral presentation by Elmore to the Electrochemical Society in May 1960 and, later, in a paper published in July 1961 in the *Journal of the Electrochemical Society.*

9. (a) The work performed by Tanner and Elmore in 1958 and thereafter was made the subject of patent application Serial No. 12, 758, filed March 4, 1960. One object of the invention was the provision of an improved porous electrode which would not impede the diffusion of gas through the electrode. Various examples of electrolytes and electrodes were described in the application, including several electrodes in which a catalytic material, such as metallic silver powder, platinum black or palladium black, is mixed with a colloidal dispersion of a hydrophobic material, polytetrafluoroethylene. As filed, the application contained claims directed to (1) a fuel combination, (2) an electrode for use in a fuel cell, and (3) a method of making the electrode.

(b) After an intensive examination in which none of the claims was found to be allowable, the application was abandoned in favor of a continuation application, Serial No. 332,812, filed December 23, 1963. Claims directed to a fuel cell using a particular electrolyte were ultimately found to be allowable but in conflict with similar claims contained in a Leib at al application, owned by Leesona Corporation. An interference was declared by the Patent Office but it was terminated when, on June 29, 1966, Leesona acquired the Elmore and Tanner application from the Kettering Foundation. The application was then abandoned, this time in favor of a con-

tinuation-in-part application, Serial No. 609,985, filed December 22, 1966, by Leesona. This application, like the previous two applications, contained claims directed to a fuel cell combination, an electrode for use in a fuel cell, and a method of making the electrode.

(c) Throughout the prosecution of the three applications, the applicants presented claims directed to a porous electrode that included a colloidal suspension of a fluorocarbon mixed with a catalytic material to maintain porosity and to permit the diffusion of gases into the electrode. There is no basis in the file histories of the three applications on which to limit the electrodes described in claims 4 and 7 of the '900 patent either to fuel cells, as distinguished from conventional batteries, or to electrochemical cells operating at temperatures of 100° C. or more. The concept of the electrode disclosed in the original application, its purposes, construction, and function, remained unchanged throughout the prosecution of the three applications. Those working in the art had long recognized the applicability of electrode technology both to fuel cells and other more conventional types of batteries, and those working with electrodes looked to developments in both areas of technology. The subject matter of claims 4 and 7 is fully supported by the original application Serial No. 12,758, and these claims are entitled to the benefit of the filing date of that application.

10. Although precise formulations are not specified, the disclosure of the '900 patent is complete and will permit one skilled in the art to make the catalyst-Teflon electrode. Those skilled in the art, without the need for any experimentation, would recognize from the concept of the patent that the fluorocarbon should be limited in amount so that the electrode would be conductive. Otherwise, the proportions of the ingredients used in the electrode are not critical and may vary widely, dependent on the particular application contemplated by the user. A 50% Teflon, 50% catalyst mixture would be entirely satisfactory.

11. The use of an admixture of Teflon and catalyst in electrodes of the type developed by Elmore and Tanner has had a substantial impact on the industry. As stated by defendant's expert, Dr. Gilman:

I can't pinpoint the date, but I would say as soon as people found out that you could get good performance with Teflon-bonded catalysts, that they all got on the bandwagon.

Subsequent to the work of Elmore and Tanner, General Electric, Monsanto, American Cyanamid, Pratt & Whitney, and Leesona all began to work with Teflon-bonded electrodes. Today, that type of electrode is one of the most efficient electrodes available and Elmore and Tanner have received recognition as being the first to develop it.

12. Electrodes using a catalyst/Teflon admixture provide a cell which permits rapid current drain at high current levels and this, coupled with the advantage of light weight, results in a high power density. Those in the art, after the invention became known, were unable to explain why these electrodes were capable of such high current drains. In 1962 or 1963, Dr. Giner developed a theory that has received acceptance in the industry, as to the mechanism of operation of this electrode. That theory, based on the concept of "flooded agglomerates," views the catalyst particles as forming porous agglomerates that are flooded with electrolyte and the Teflon particles as creating hydrophobic gas channels. The reactant gas diffuses through the Teflon channels to the flooded agglomerate sites throughout the volume of catalyst where it participates in the three-phase reaction.

Dr. Giner's work in the development of this theory was, in part, funded by defendant through the research organization at Fort Belvoir, Virginia. As of now, his theory remains as the best explanation for the operation of these electrodes.

Plaintiff's expert, Dr. Frysinger, was, for many years, employed first at Fort Belvoir and then at the Electronics Command at Fort Monmouth (ECOM), and has a long history of involvement with the development efforts of the battery and fuel cell industry. He testified in support of Dr. Giner's theory and pointed out how, in light of that theory, the prior art electrodes differed from the Elmore and Tanner work. Defendant's expert, Dr. Gilman, did not dispute the theory advanced by Dr. Giner, and recognized the uniqueness of the Teflon-bonded gas diffusion electrode but contended that

these electrodes were first made by personnel at General Electric. This testimony was based on the work performed by Niedrach, as described in United States Patent No. 3,297,484.

13. (a) The most pertinent prior art is Berl Patent No. 2,275,281, a patent also considered by the Patent Office. The porous carbon of the electrode shown in Fig. 2 of the '900 patent is used as a suport for the catalyst layer in the identical manner to the carbon block in Berl. The active layer in both Berl and the '900 patent have the same electrochemical function, *i.e.*, the reduction of oxygen from the air by an electrochemical process. The electrode of the '900 patent differs from Berl in the choice and function of the polymer and catalyst mixture.

(b) In Berl, the wet-proofing polymer was intended to control penetration of the electrolyte into the porous carbon. This was achieved by dissolving the polymer, ethylcellulose, and mixing powdered carbon into the solution, thereby causing the particles of carbon to be coated, at least in substantial part, with the polymeric material. When dried, the polymer serves as a binder to hold the carbon particles together and, to the extent it is hydrophobic, the polymeric material will restrain penetration of the electrolyte into the electrode. The result is a line, defined by the limited penetration of electrolyte, where the electrolyte, gas, and catalyst come together and along which the necessary three-phase reaction occurs.

(c) Under Dr. Giner's theory, the electrode of the '900 patent has a wholly different structure from prior art such as that of Berl in that instead of the catalytic particles each being coated with the hydrophobic substance, in effect none of the particles has any coating at all. The particles are in intimate contact with each other in a substantial volume of the electrode, with the Teflon particles being dispersed throughout the electrode. When exposed to a gas and an electrolyte, the electrolyte will wet the catalyst particles throughout a substantial volume of the electrode and the chain of Teflon particles, which are hydrophobic but gas permeable, provides a path through which the gas may permeate the electrode to join with the electrolyte and the

catalytic material for the three-phase reaction. Rather than occurring along a line, the reaction will occur throughout the volume of the electrode thereby providing an electrode of greatly increased capacity.

14. Polytetrafluoroethylene was available by at least 1951. By at least 1954, du Point had published a catalog detailing the properties and characteristics of its Teflon resin. By 1958, it had been suggested to use ethylcellulose, polyvinyl chloride, polyethylene, polystyrene, or rubber as binders in preparing porous electrodes. No one had suggested using a fluorocarbon such as Teflon, although its hydrophobic propties were then known. The use of Teflon was confined to dipping an electrode in it in a conventional wet-proofing treatment, as disclosed in Reutschi Patent No. 2,951,106. Almost all of the work with plastic materials as binders used solutions of the material. Teflon is essentially insoluble. In 1954, Witherspoon et al investigated porous electrodes using plastic binders and concluded that the film coating achieved by materials such as rubber was superior to a particle mixture of polyethylene.

15. The BB–626 ( )/U battery is an electrochemical cell for the direct generation of electrical energy having an anode and a nonconsumable cathode with a catalytic layer (the black side) consisting of an admixture of materials including platinum black (an electrocatalyst) and a fluorocarbon (Teflon). The catalytic layer is exposed to the electrolyte of the cell and has a porosity sufficient to permit diffusion of gases (air) into the catalytic layer.

Patent No. 3,276,909

16. The electrode structure described in the '909 patent comprises a porous polymeric matrix having a porous conductive, catalytically activating metal layer in intimate contact with one surface of the matrix. The function of the polymeric matrix is to support the catalytic material and control the electrolyte/reactant gas/electrode interface. The patent suggests that either a hydrophobic or hydrophilic polymer may be employed. If a hydrophobic polymer is used, it must be in contact with the reactant gas; if a hydrophilic polymer is used, it should be in contact with the electrolyte.

Claim 9, the only claim in suit, specifies a hydrophobic polymer. Teflon, a fluorinated hydrocarbon, is a hydrophobic polymer.

17. (a) The Patent Office relied on Williams et al Patent No. 3,116,170 in rejecting claim 9 (claim 26 in the application). That patent discloses a fuel cell in which the electrode comprises a porous polymeric matrix having a porous conductive catalytically activating metal layer in intimate contact with one surface of the matrix. Wiliams positioned the electrode with the polymeric material facing the electrolyte and, through careful selection of the pore size of the material, the electrolyte would penetrate through to the catalytically active layer. Williams' preferred material is a hydrophilic polyvinyl chloride but a hydrophobic material such as polyethylene is also suggested.

(b) The only difference between claim 9 and the Williams et al patent is in the orientation of the polymeric matrix, the claim specifying that the catalytically activating metal layer faces the electrolyte instead of the gas. The Patent Office allowed claim 9 after plaintiff submitted the results of a comparative test that showed that a hydrophobic polymer-catalyst combination, oriented in the manner claimed, as compared to a hydrophilic polymer-catalyst combination, oriented in the manner disclosed in Williams, gave dramatically improved performance. For example, at a potential of 700 mV, the claimed arrangement obtained a current density of over 75 ma/cm^2 as compared to about 17 ma/cm^2 with the Williams orientation. These same tests showed that there was only a small difference in the performance of a hydrophilic polymer-catalyst electrode when its orientation was reversed.

(c) The results of the comparative tests were contained in an affidavit submitted to the Patent Office and executed by Anthony Moos. The affidavit represented that the affiant held a degree of Doctor of Science in Physical Chemistry from the University of Paris. That representation was incorrect in that he does not hold a doctoral degree. The tests conducted and reported in the affidavit were of a factual nature and did not depend upon the technical qualifications of the affiant for their validity. The bases for the comparative tests conducted and reported to the Patent Office were

fully and accurately disclosed to the examiner and were appropriate for the limited purpose for which they were conducted, *i.e.*, to show the effect of orientation of the polymer matrix.

(d) Both the test results submitted to the Patent Office by plaintiff, and other evidence in this case, demonstrate that the dramatic increase in current density obtained with a hydrophobic polymer matrix would not be obtained with a hydrophilic material, irrespective of its orientation. In experiments conducted at Pratt & Whitney, electrodes using Teflon as the polymer and platinum black as a catalytic material were investigated. These experiments confirmed the advantageous nature of those electrodes and suggested that the flooded-agglomerate theory of Giner as applied to the Teflon-bonded electrodes of Elmore and Tanner (finding 12) might also be applicable to a layered electrode of the Moos type.

18. There is no serious dispute that electrodes using a Teflon layer to support a catalytic layer represent a distinct advance in the electrode art. Dr. Giner considered it to be one of the two most efficient electrodes known, the other one being the Teflon-bonded electrode of the type disclosed in in the '900 patent. Dr. Frysinger was of the same opinion. Defendant's expert, Dr. Gilman, was of the view that a Teflon-backed electrode wherein the catalytic layer was Teflon-bonded is the best electrode at room temperatures known today.

19. In the Bacon-type cell, in which a biporous electrode is employed, the fine-pore structure where the desired reaction occurs faces the electrolyte and the coarse-pore structure faces the gas. To prevent penetration of the electrolyte into the coarse pores, it was necessary to establish a pressure differential which allowed the electrolyte to penetrate only the small pores. This was critical to the operation of the cell. When Williams proposed to use a layered electrode with a plastic matrix in lieu of the biporous structure, he reversed the orientation of the layers, placing the catalytic layer toward the gas and the plastic layer toward the electrolyte. In effect, the pore size of the plastic layer in Williams served as a gate that permitted only a controlled permeation

of the electrolyte into the catalytic layer but provided unlimited access of the gas to that layer. In both Williams and Bacon, penetration of the electrolyte was the variable being controlled, in Bacon by the biporous structure and a pressure differential and in Williams by the pore size of the plastic film. Other prior art attempts at controlling the electrolyte include the use of paste electrolytes, electrolyte-impregnation techniques, and ion exchange membranes. The Moos electrode in which a hydrophobic layer is employed takes an approach opposite both to Bacon and Williams, and to the other prior art. He provides no control over the penetration of the electrolyte into the catalytic layer, allowing it to be entirely flooded by the electrolyte, and relies on the hydrophobic film or membrane as a gas-permeable barrier. Also contrary to Williams, Moos placed the polymer matrix on the gas side, an orientation that was inconsistent with the prior art concept of providing unrestrained access of the gas to the reactive layer.

20. General Electric was heavily involved in fuel cell research in the late 1950's and early 1960's. A substantial portion of their research effort was directed to the development of a cell that could operate satisfactorily at ambient temperatures and pressures. In 1959, the work at General Electric was, at least in part, devoted to work on the use of ion exchange membranes. In 1961, almost 3 years after Elmore and Tanner conducted their experiments, and over 1 year after their application had been filed, General Electric filed an application, disclosing the use of a Teflon-bonded electrode, asserting the improved performance of these electrodes over prior art electrodes. As of the filing of that application, General Electric was using an electrolyte-impregnated solid matrix as a technique for restraining the electrolyte. In October 1962, a year and a half after the Moos application was filed, General Electric filed another patent application, disclosing a layered electrode made up of a hydrophobic polymeric matrix (Teflon) with a Teflon-bonded catalytic layer supported thereon. The application disclosed that the Teflon matrix was oriented toward the gas and stated that the "surprising" result was the good performance of the electrode.

Findings of Fact

21. On March 11, 1966, plaintiff filed a patent application in the name of Harry G. Oswin in which plaintiff sought to obtain claims directed to the Moos electrode disclosed in the '909 patent, but in the context of a metal/air battery. During prosecution of that application, plaintiff took the position before the Patent Office that the '909 patent did not disclose the use of the Moos electrode in a metal/air battery and that there was no teaching in the '909 patent that the Moos electrode could be used advantageously as the air-depolarized cathode in an air battery. Failing to persuade the Patent Office of its position, plaintiff appealed to the United States District Court for the District of Columbia. In connection with that proceeding, Civil Action No. 1537–69, plaintiff and the Patent Office entered into a stipulation that the electrodes of the '909 patent are generic to all fuel cells, including simple fuel cells such as metal/air batteries. Although Moos testified in the District Court that he had contemplated that his electrode would, at all times, be operated under a positive gas pressure and it was his belief at the time that it would not be operable under atmospheric conditions, the District Court concluded that one of ordinary skill in the art would readily recognize that the Moos electrode could be used as an air cathode in a metal/air battery.

22. The BB–626 ( )/U battery utilizes an electrode comprising a porous hydrophobic polymer matrix (the white side consisting of PTFE) and a porous conductive catalytically activating metal layer (platinum black) on one side of the PTFE. The battery is a fuel cell for the generation of electrical energy from a fuel and an oxidant. The means for supplying the reactants to the electrodes include openings in the housing through which air is supplied to the cathode. The fuel cell reactant at the anode is the zinc which is a part of the anode construction and is supplied on a batch basis each time a spent anode is replaced with a fresh one.

23. (a) On February 21, 1958, plaintiff and defendant, through its Department of the Navy, entered into contract NOas 58–414–c, the purpose of which was to fabricate, test, and furnish to the Navy, on a cost-plus-fixed-fee basis, a fuel cell capable of producing certain levels of power, the total contract price being $128,779.50, of which $7,290 was the fee.

Work under this contract commenced on May 1, 1958; the actual experimental work terminated as of about January 1960; the available funds were exhausted by September 28, 1960; and a cell was delivered to defendant in October 1961. The contract contained the standard patent rights clauses, which state:

> (a) * * *
> (i) The term "Subject Invention" means any invention, improvement or discovery (whether or not patentable) conceived or first actually reduced to practice * * *
> * * * in the performance of * * * work called for or required under this contract * * *
> * * * * *
> (b) (1) The Contractor agrees to and does hereby grant to the Government an irrevocable, nonexclusive, nontransferable, and royalty-free license to practice * * * each Subject Invention * * *
> * * * * *
> (2)
> * * * * *
> (iii) * * * Nothing contained in this Patent Rights clause shall be deemed to grant any license under any invention other than a Subject Invention.
> * * * * *

(b) The contract did not require a Bacon-type fuel cell; however, plaintiff's work under this contract, as well as under a contemporaneous Air Force contract, was devoted to that type of cell. Both the Navy and the Air Force were aware of the nature of the work being performed and neither raised any objection. In attempting to improve the biporous nickel electrodes theretofore used in Bacon cells, plaintiff experimented with a Teflon-coated coarse-pore metal plate and evaluated its bubble pressure characteristics. Experimental work with Teflon-coated plates extended through June, July, and August 1958, in an attempt to come up with an electrode having an acceptable bubble pressure. Finding no improvement in bubble pressure, plaintiff never tested the electrodes or used them in a cell and that phase of the work was abandoned. However, the substance of the work was duly reported to the Navy in three monthly progress reports.

Similar work had been performed by plaintiff in January 1958, prior to this contract, when a hydrophobic silicone material had been coated on a coarse-pore metal plate and evaluated for bubble pressure.

(c) The fuel cell ultimately supplied to the Navy was a Bacon-type cell constructed in England, together with certain subsystems developed by plaintiff. These subsystems included a gas control system, a hydrogen circulation-water vapor removal system, and a cryogenic fuel storage system. By January 1960, the Bacon cell had been ordered from England and no further work on electrode development was being performed, it having been determined to use porous sintered nickel electrodes in a circular configuration.

(d) The Navy was of the view that plaintiff made no contribution or invention in the field of fuel cells and electrodes during the course of this contract. Although the fuel cell delivered to the Navy did not fulfill the terms of the contract, none of the fuel cell contracts then being performed were successfully completed. Plaintiff and the Navy entered into a supplemental agreement reducing the fixed fee by some $2,000, which represented an adjustment related to the percentage of completion of the contract, and the Navy considered the contract closed after the hardware had been delivered.

(e) Moos' work on which the '909 patent is based was performed in late summer or early fall of 1960, during the course of experimental work funded by plaintiff on various hydrophobic and hydrophilic sheets and their orientation with respect to the gas and the electrolyte. None of this work was related to the sintered nickel electrodes plaintiff was supplying to the Navy, those electrodes having been procured from England. At the time plaintiff made the decision to supply the Navy with electrodes and a Bacon cell from England, that type of cell had the highest theoretical current density of electrode area of any known fuel cell.

Patent No. 3,438,815

24. This patent discloses a layered electrode construction in which a Teflon-bonded catalytic layer is combined with a microporous layer serving as the support for the catalytic layer. The specification states that the metal layer should

have a pore size in the range of 1 to 50 microns in diameter in order to establish the desired bubble pressure. In one embodiment, the patent discloses an electrode consisting of a Teflon layer, a Teflon-bonded catalytic layer, and a microporous metal layer. Claim 12, on which claims 15 and 16 are dependent, is as follows:

> An electrochemical cell for the generation of electrical energy comprising an electrolyte chamber containing an electrolyte, at least one oxidant electrode, at least one fuel electrode, said electrodes partially defining said electrolyte chamber and being in contact with said electrolyte, at least one of said electrodes being a sandwich-type structure wherein a porous conductive catalytically activating layer consisting essentially of a hydrophobic polymer and catalytic metal particles is in intimate contact at one surface with a porous hydrophobic polymer matrix and the second surface is in contact with a porous self-sustaining metal layer of uniform and controlled porosity, said porous self-sustaining metal layer facing the electrolyte chamber and said porous self-sustaining metal layer being in contact with the electrolyte of the cell.

25. In light of the patent specification and the arguments advanced to the Patent Office, the limitation in claim 12 of a "porous self-sustaining metal layer of uniform and controlled porosity" must be restricted to porosities in the microporous range.

26. The expanded metal grid in the accused battery is not a micro-porous structure; it is not used as a device to control bubble pressure, nor does it do so. Its only function is that of a current collector. The use of screens as current collectors was known in the art long prior to the filing date of this patent, as shown, for example, in the '900 patent in suit, and in Niedrach et al Patent No. 3,432,355.

Patent No. 3,553,024

27. This patent discloses an electrode comprised of an unsintered Teflon layer and a catalytic layer. This sintering temperature of Teflon is 327° C. The patentee points out that, when Teflon is heated above 327° C., the porosity of the Teflon structure is decreased and small cracks or breaks occur in the Teflon sheet. Although these cracks or breaks

do permit the diffusion of gas through the sintered Teflon, they may also permit electrolyte to leak through, resulting in a condition known as weepage. Claim 1, the only independent claim, is as follows:

> An electrochemical device comprising a fuel electrode, an oxidant electrode, and an electrolyte in contact with each of said electrodes, at least one of said electrodes being non-consumable and electrochemically active with a reactant material and comprising a continuous polytetrafluoroethylene film fabricated below the transition temperature of polytetrafluoroethylene which is 327° C., said film being gas permeable and free from liquid aqueous electrolyte seepage and a catalytic material comprising an electrocatalyst in intimate contact with one surface of said film, said catalytic material being in contact with the electrolyte of the device and said polytetrafluoroethylene film being exposed to said reactant material, said electrode being fabricated at a temperature below the transition temperature of polytetrafluoroethylene, which is 327° C.

Dependent claims 3, 4, and 6 add details regarding the Teflon-bonded electrode while dependent claim 11 is directed to a consumable zinc anode. None of the features described in these claims was developed by the patentee Fishman.

28. (a) In the '900 patent of Elmore and Tanner, it is stated that the mixture of silver powder and Teflon should be heated only to about 300° C., at which temperature "the Teflon is not heated to the point where the open porous structure of the Teflon-silver mixture might be destroyed."

(b) In the Moos '909 patent, specific examples for producing electrodes are given. Examples 1 and 2 disclose a silverized polyethylene sheet. The temperatures employed in the processing of the polyethylene do not exceed 150° C. The patent states that polytetrafluoroethylene could be substituted for the polyethylene in both of the examples. If such a substitution were made, the fabrication process described in those examples would not sinter the Teflon.

(c) Croze et al Patent No. 2,689,805, issued in 1954, describes a Teflon film coated with thin metallic layers. This patent discloses that unsintered Teflon is porous to air while sintering of Teflon renders it nonporous.

(d) Advertising literature, circulated by du Pont in 1957, described Teflon as having very low permeability after it has been sintered.

(e) Unsintered Teflon film was commercially available in April 1961, the filing date of the Moos '909 patent. In his experiments in 1964, the patentee Fishman used a commercially available unsintered Teflon film.

Patent No. 3,436,270

29. (a) This patent discloses a mechanically rechargeable metal/air cell having a gas permeable envelope cathode, *i.e.*, a cathode in an envelope configuration which forms a complete enclosure closely surrounding the anode. A metal anode and electrolyte are contained within the space defined by the envelope cathode. The cell is recharged merely by removing an expended anode and replacing it with a fresh anode. The anode is a metallic material and the electrolyte is preferably trapped in a suitable matrix or wrapper surrounding the anode. The wrapper serves as an insulator between the anode and the close-fitting cathode.

(b) The anode-cathode structure of the '270 patent lends itself to a compact design requiring only a low volume of electrolyte. A high energy-to-density and high energy-to-volume cell capable of high current drains can be achieved. This is in large part due to the Teflon-layered electrode structure but also in part due to the envelope configuration and the close-fitting relationship between the anode and cathode. In effect, this relationship is analogous to a letter and its envelope, the anode being the letter and the cathode the envelope, thus providing a minimum electrode spacing, a minimum quantity of electrolyte, and intimate contact among the cathodic surfaces, the separator, electrolyte, and the anodic surfaces. It further contributes to high-anode utilization with minimum electrolyte requirements. No prior art system was capable of using two porous electrodes with low-electrolyte requirements.

(c) The term "bi-cathode" was used in the specification and claims as originally filed. After interviews with the examiner, and in an amendment filed February 23, 1968, applicants' attorney amended the claims to call for an "envelope" cathode. In making this amendment, it was stated:

Findings of Fact

In order to more accurately define the present invention, the claims have been amended to read "envelope cathode" in place of "bi-cathode." In view of the modifications to the claims, to have conformity, the specification has been amended at page 4, line 19, to indicate that the term "bi-cathode" and "envelope cathode" are synonymous.

As defined in the RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 477 (1967), "envelope" means to enclose or surround.

30. (a) Defendant does not seriously contest infringement of the claims of the '270 patent here in issue. In support of its defense of obviousness, defendant relies on the following prior art patents:

Langer	No. 409,365
Waddell, et al	No. 461,858
Lavison	No. 668,838
Winckler, et al	No. 2,641,623
Hollman, et al	No. 2,727,083
Moos	No. 3,276,909
Southworth, et al	No. 2,907,809
Thompson, et al	No. 2,044,923
Heise	No. 1,899,615
Berl	No. 2,275,281
Niedrach, et al	No. 3,432,355

(b) These patents, with the exception of Heise and Thompson, are pertinent only to show that certain features such as zinc anodes, separators wrapped around anodes, and entrapped electrolytes were known prior to the filing date of the '270 patent. As is apparent from the prior art, the conventional metal/air or railroad battery had no provision for recharging. When the anodes were consumed, the battery was either discarded or, with some, a new cathode-anode assembly was used to rebuild the battery. The electrolyte was almost always shipped separately and was added to the battery when it was ready to be activated. The volume of electrolyte was made as large as possible. The conventional secondary battery, such as the silver-zinc BB-451/U battery of the Marine Corps, required battery-charging equipment and a considerable period to effect the recharge.

(c) Heise discloses a metal/air battery consisting of an anode, cathode, electrolyte, and current collector mounted in a hinged, rigid, boxlike frame to allow the ready removal of

the anode and cathode. A substantial space is provided between the anode and cathode surfaces. This battery is a so-called "reserve" type in that some part of the battery is left unassembled to prevent its discharge until the battery is ready to be used. Heise suggests that the anode may be kept separate. Alternatively, the paste electrolyte may be held in reserve or an anhydrous assembly requiring the addition of water may be employed. There is an express disclosure in the patent of "replacement" of the anode (p. 1, col. 2, line 69). This replacement process would involve the steps of removal of the spent anode from between the two cathodes and replacement of that anode with a fresh anode.

(d) Thompson et al discloses an air-depolarized battery utilizing a carbon cathode and a zinc anode, designed so that the zinc anode may be replaced after it is exhausted. Thompson contemplated that the life of the anode would be approximately the same as the active chemical part of the electrolyte so that both the anode and the electrolyte would be changed at the same time.

31. (a) Defendant also relies on work by General Electric in developing a magnesium-air battery under Task 89, a Government-financed project for an undisclosed agency, as an anticipation of the '270 claims. That battery has a mechanical recharging capability, using replaceable magnesium anodes with salt water as the electrolyte. The anode-cathode structure is shown in Kent Patent No. 3,457,115, filed December 3, 1965, and issued July 22, 1969.

(b) Plaintiff's contention that the Oswin-Chodosh invention was conceived in October 1964, and reduced to practice by December 1964, has not been satisfactorily proven. The invention disclosure form executed by the inventors is dated May 3, 1965; it contains only a broad description of the idea of replacing anodes. There is no mention of any specific embodiment and no description of an envelope cathode. The indication in earlier reports that cathodes had been tested repeatedly against anodes is ambiguous at best and does not corroborate the oral testimony of plaintiff's witnesses. There is no persuasive evidence that an envelope cathode was conceived by plaintiff prior to G.E.'s work.

Findings of Fact

(c) In June 1964, G.E.'s work on a magnesium-air battery included consideration of a configuration in which a single anode was positioned between two cathodes. By October 1964, G.E. had devised the basic anode-cathode structure shown in the Kent patent and had operated cells using that configuration. This basic structure included a pair of cathodes with an anode removably positioned therebetween for mechanical rechargeability. Although some leakage problems were encountered with this battery throughout the Task 89 program, the workability of the basic configuration and the mechanical rechargeability of the battery had been demonstrated before the end of 1964.

(d) In October 1964, Leesona began formal consideration of a program for the development of an air-depolarized battery. Up to that time, its major efforts had been in fuel cells and batteries other than metal/air batteries. As of that time, Leesona had completed some experimental work on metal/air cells and had demonstrated the superiority of the Teflon electrode to the prior art electrodes; however, the envelope cathode and the rechargeable concept had not yet been developed. By December 1964, an evaluation of a bi-cell, consisting of two cathodes supported on a frame with an anode in between, had been completed. Documents dated in April and May 1965 are the first clear disclosures of an envelope cathode and the mechanical-recharging concept.

(e) On November 20, 1964, the United States Army Electronics Laboratories issued technical guidelines for research and development work in the field of metal/air batteries. These guidelines were republished on March 5, 1965, but with the additional provision:

> 6. A study of cell rechargeability (i.e. replacement of spent anodes and electrolytes with fresh materials) shall be made. Cell design should be such that this recharging can quickly, easily, and safely be accomplished. * * *

(f) General Electric's work under Task 89 extended from June 1964 to August 1965. The substance of the work performed was periodically reported to the secret customer but was otherwise maintained secret and confidential within G.E. The filing of the Kent application on December 3, 1965,

was the first step taken by G.E. toward a public disclosure of this work.

32. (a) The combination of an envelope cathode and removable anode was new to the field of metal/air batteries. None of the prior art had used a cathode both in a close-fitting relationship to a removable anode and to serve as a receptacle for the electrolyte. The essentially contemporaneous work of G.E. in developing the magnesium/air battery evolved a removable anode but the cathodes on the opposed sidefaces of the boxlike frame are spaced apart a substantial distance, much like the Heise arrangement, and this spacing, together with the rigidity of the box structure, precludes a close-fitting, intimate engagement of the cathodes and anode. Like conventional railroad batteries, a substantial volume of electrolyte, 9 grams/ampere hour, is required for the G.E. structure. Dr. Frysinger testified that tests he conducted revealed that the G.E. battery produced 28.8 watt hr./lb. while plaintiff's battery with the close-fitting envelope cathode produced over 100 watt hr./lb. and that the difference in performance was due to the envelope cathode structure.

(b) In the period 1966–68, the Marine Corps instituted a program to determine whether metal/air batteries could be used to power its radio sets in lieu of the silver/zinc batteries, the BB–451/U, then being used. Three metal/air batteries were tested, the G.E. magnesium/air battery developed under Task 89, a zinc/air battery of Yardney Electric and plaintiff's zinc/air battery. Each of these used a replaceable anode. The G.E. and Yardney cells were of substantially the same construction, employing the boxlike cathode structure. Plaintiff's cells used the envelope cathode. The G.E. cells were rejected at an early stage of testing due to an inability to produce sufficient electrical energy. The Yardney battery was also rejected. After complete testing of plaintiff's battery, including field tests in Vietnam, the Marine Corps reached the conclusion that plaintiff's battery should replace the BB–451/U. The tests revealed that, in addition to superior capacity and cycle life, plaintiff's battery with the envelope cathodes and removable anodes could be recharged in 10 minutes as compared to the 10 hours required for the BB–451/U.

Findings of Fact

33. The method steps recited in claim 19, *i.e.*, (1) discharging the metal anode, (2) removing the discharged anode, and (3) inserting a fresh anode, are all disclosed or inherent in Heise. Claim 19 differs from Heise only in the specific structure of the envelope cathode recited in the claim. G.E.'s work under Task 89 also used the same method steps for replacement of the anode.

34. (a) On June 15, 1965, plaintiff entered into a cost-plus-fixed-fee research and development contract, AF 33(615)-2680, with defendant's Wright-Patterson Air Force Base, to provide a high discharge rate, high specific energy electrochemical power source for aerospace applications. Under this contract, plaintiff was to select a couple, conduct experimental work on the couple, and build and test cells and batteries using the selected couple. Specific performance requirements were listed in the contract. The standard patent rights clauses were included in the contract.

(b) Plaintiff selected an aluminum/oxygen couple as its first choice to investigate, with zinc/oxygen as a second choice. Defendant was advised by plaintiff that Leesona had its own inhouse program on zinc/air batteries.

(c) Plaintiff's detailed studies of the aluminum anodes indicated that greater research effort than allowed under the contract would be required. The Air Force decided that the effort should be redirected to defining the limitations of the aluminum/oxygen system and to providing a zinc/air battery for evaluation. This redirection of effort was formalized in a supplemental agreement dated March 4, 1966, under the terms of which plaintiff's fixed fee and the estimated cost were reduced by about two-thirds.

(d) Prior to any work under this contract, plaintiff had the concepts of a mechanically rechargeable zinc/air battery, had built batteries using those concepts, had tested the batteries, and had prepared data in a brochure describing the battery. Plaintiff's mechanically rechargeable zinc/air battery was demonstrated by plaintiff to military personnel on or about September 9, 1965, and one was delivered to the Engineer Research and Development Laboratories at Fort Belvoir, Virginia, on or about December 30, 1965.

(e) Although certain aspects of the technology developed by Leesona were employed in the work performed under this contract, none of that technology was either first conceived or first reduced to practice thereunder; rather, it was previously developed under internal programs of Leesona and funded by Leesona.

Patent No. 3,378,406

35. (a) This patent discloses a battery of cells employing the envelope cathode and replaceable-anode concept of the '270 patent and adds the feature of intercell spacers between the cathodes to allow free and direct access of air over the entire surface of the cathode. With the particular spacers disclosed, a plurality of cells may be stacked in a compact configuration while yet providing the requisite air flow to the cathode to obtain a high-energy output. The spacers exert pressure against the faces of the cathodes so that the desired intimate contact of the electrodes is maintained. The spacers also tend to prevent cell "growth" by exerting pressure against the cathode face.

(b) The claims of the '406 patent were allowed after two interviews with the examiner. There were no formal office actions by the Patent Office on the merits of the application. The only advantage of the claimed combination stated by the applicant to the Patent Office is summed up in the following statement from one of the two amendments submitted by plaintiff:

> * * * the inventive feature of the present disclosure is the provision of a metal/air or metal/oxygen battery comprising a plurality of cells, each of which has a cathode surface which needs to be in contact with air or oxygen for operation. The objective is accomplished by having a spacer element having openings for the passage of air or oxygen positioned between adjacent cells of a stack. These spacer elements can be integral with, or separate from the cathode.

(c) Rosansky's contribution to the combination set forth in claims 1, 3, 8, and 9 rests solely on the spacer elements recited. At trial, Dr. Chodosh testified that the intercell spacers perform several important functions in that they allow "specific quantities" of air to the cathodes, not enough

to create a dry-out problem but enough to avoid polarization and overheating. The patent specification states that the "essential feature" (col. 3, lines 31–33) of the spacers is to permit access of air to the cathodes. There is nothing in the specification about limiting the air to a specific quantity; nor is there any structure recited in the claim that would inherently perform such a function.

(d) Claims 1 and 3 are directed to the same basic combination as claim 2 of the '270 patent. Each of these claims calls for a plurality of cells, with each cell comprising:

1. An envelope cathode comprising a hydrophobic polymer membrane and a conductive catalytic coating on the inner surface.
2. A metal anode positioned within each envelope cathode.
3. An electrolyte in the space separating the anode and cathode.
4. Means for retaining the elements of the cells in operable association.

Claim 1 of the '406 patent adds to the combination the provision of intercell spacers.

36. The use of spacers between electrode surfaces was well known long prior to 1965 to those in the battery and/or fuel cell field. Jaffe Patent No. 3,005,943, for example, teaches an oxygen electrode made up of a plurality of thin sheets arranged in a stack with spacers between each sheet, the spacers being a woven mesh screen that allows the oxygen to contact the faces of the sheets. Mond et al Patent No. 409,365 and Vahldieck Patent No. 3,012,086 likewise teach that spacers may be positioned between a stack of cells to provide access for the flow of gas over the electrode surfaces. Porous separators between adjacent electrodes have also been used, as shown in Hollman et al Patent No. 2,727,083; and other types of spacers are shown in Ruetschi Patent No. 2,951,106, Bacon Patent No. 2,969,315, Langer et al Patent No. 3,252,839, and Harris Patent No. 1,297,157. The G.E. work on a magnesium/air battery (finding 31) included the use of spacers that defined openings between the stacked cells to provide access of air to the cathode surfaces. At about this same period of 1964–65, Eagle-Picher designed a zinc-oxygen system (ZOX) in which spacers were used between stacked cells. Those with

ordinary skill in the art would have readily recognized that the flat cells of Heise Patent No. 1,899,615 also could be stacked together and that spacers would have to be provided between adjacent cells to permit air access to the cathode surfaces.

Patent No. 3,531,327

37. This patent discloses a substantially liquid and substantially gas impermeable package containing all of the anolyte elements, *i.e.*, metal anode, separator material, and electrolyte, necessary for the complete recharge of a mechanically rechargeable cell of the type disclosed in the '270 patent.

Claims 1, 2, 3, 8, and 9 are accused to be infringed and are as follows:

> 1. As a new article, an assembly including select elements for use with metal/air depolarized cells, said cells comprising as essential elements an air depolarized cathode, a consumable metal anode, a hydrophilic separator, and a material capable of functioning as an electrolyte in aqueous solution, said assembly including from said essential elements only said anode, said hydrophilic separator, and said material, said hydrophilic separator disposed around and in contact with said anode, at least one of said separator and anode including a quantity of said material capable of functioning as an electrolyte in aqueous solution, said quantity of said material in said separator and anode constituting the sole source of electrolyte material and being sufficient to operate the metal/air depolarized cell substantially over the life of said anode when disposed in said cell without requiring additional electrolyte material or any other material with the exception of water, and a substantially liquid and substantially gas impermeable envelope enclosing said assembly.
>
> 2. The article of claim *1* wherein the electrolyte material is an alkaline material.
>
> 3. The article of claim *2* wherein the alkaline material is potassium hydroxide.
>
> * * * * *
>
> 8. The article of claim *1* wherein said anode comprises a porous metal body.
>
> 9. The article of claim *8* wherein the metal is zinc.
>
> * * * * *

Findings of Fact

38. (a) Work on storing anodes in bags commenced at Leesona in the summer of 1965, when a few anodes, activated by immersion in electrolyte, were placed in polyethylene bags. The anodes were left in storage for varying periods and then tested to determine the effect of storage on their capacity. This program continued on a limited scale through 1965 and into 1966. In April 1966, a comprehensive storage analysis program was instituted to ascertain wet storage life of a zinc anode and separator impregnated with electrolyte, and to determine the importance of certain variables in that storage life. Evaluation of suitable packaging for the anode continued to July 1967, by which time it was decided that polyethylene was inadequate in preventing moisture penetration and consequent loss of capacity and dimensional changes in the stored anodes. As a temporary measure, a composite wrapper of Aclar, Mylar, and polyethylene was adopted. Ultimately, satisfactory wrappers were found to be made up of layers of polyethylene, Mylar, aluminum foil, and Kraft paper.

(b) The polyethylene bag employed by Leesona in its early work was not a substantially liquid impermeable envelope, when considered in the context of the objectives sought to be achieved. Because of the moisture permeability of that material, the packaged anodes had diminished capacity and were not suitable for use after extended storage. The first assembly of a metal anode, separator, and electrolyte in a substantially liquid and gas impermeable package susceptible of extended storage without undue loss of capacity was made in 1967.

39. On March 21, 1966, plaintiff entered into contract DA 28–043 AMC–02082(E) with the procurement division of the United States Army Electronics Command (ECOM) at Fort Monmouth, New Jersey. That contract covered 12 items of work, including the supply of 10 24-volt metal/air battery systems with 300 anode electrolyte recharge kits, and 12 60-watt metal/air battery systems with 672 anode electrolyte recharge kits. The contract price was $300,000, with plaintiff obligated to expend up to an additional $100,000 of its own funds without reimbursement should the cost exceed the contract price. The contract included the standard

patent rights provision; however, it was agreed that the contracting officer would attempt to obtain a deviation to that provision which would exclude any preexisting invention that might be first actually reduced to practice in the performance of the contract. No deviation was obtained. Work under this contract extended through 1967, and beyond. Plaintiff's storage tests on packaged anodes were directly related to its performance under this contract.

Additional Findings

40. (a) A number of contracts were awarded to plaintiff by ECOM in the period 1966–68, the purpose of all of which was to militarize Leesona's mechanically rechargeable zinc/air battery. Each of the contracts contained a patent rights clause.

(b) Contracts were also let in 1967 to General Electric and Yardney for the development of a mechanically rechargeable metal/air battery. The batteries they produced were unsatisfactory and their contracts were terminated in late 1967. The effort then continued with Leesona. By September 1968, defendant had tested plaintiff's battery, found it performed exceptionally well, and determined it to be the only one that met the military power requirements and also the environmental and ruggedness requirements for military field operation.

(c) Various comparative tests conducted by defendant have demonstrated the superiority of plaintiff's battery, to the conventional silver-zinc battery. For example:

	Leesona	*Silver/zinc*
Capacity	25(+) amp hrs	9.5 amp hrs.
Cycle time	21 hrs. 7 min	11 hrs. 16 min.
Recharge time	10 min	10 hrs.
Weight	12.5 lb	16.5 lb.

In terms of energy density, defendant evaluated plaintiff's battery at around 100 watt hours per pound, twice that of the closest competing battery system. Plaintiff's battery was voted one of the outstanding inventions in the 1966 industrial research competition, and has been enthusiastically received by the military, which has viewed it as a "significant improvement" over prior art systems and a "new important power source."

Findings of Fact

41. After successful testing of the Leesona battery in 1968, immediate adoption and procurement was recommended by the Marine Corps. Initially, defendant intended to procure the batteries from plaintiff as the sole source; however, it was later decided the procurement would be on a limited competitive basis. Plaintiff then offered to, and did, assist in preparing the technical portion of the request for proposal issued to prospective bidders.

Plaintiff was runner-up in the subsequent bidding, Eagle-Picher submitting the low bid. After the contract was awarded to Eagle-Picher, plaintiff filed a protest of the award, but it was rejected. The BB-626( )/U battery procured by defendant from Eagle-Picher is a substantial copy of plaintiff's metal/air battery.

42. During the course of its work in militarizing its battery, plaintiff made certain modifications and improvements. Some of these are the subject of issued patents or pending applications. The parties have entered into express royalty-free licenses for the inventions disclosed and claimed in the following patents or applications:

Patent No. 3,513,030 (anode terminal jack construction)
Application S.N. 627,196 (voltage regulator and blower arrangement)
Application S.N. 627,194 (metal anode and wrapper)
Patent No. 3,595,700 (method of making electrodes)
Patent No. 3,474,324 (voltage regulator)
Patent No. 3,592,693 (electrolyte impregnated anode)
Patent No. 3,630,785 (separator construction)

Each of the license agreements includes the following provision: "Nothing contained herein shall be deemed to grant, by implication or otherwise, any license to the Government under any invention other than those covered by the aforesaid application for patent."

CONCLUSION OF LAW

Upon the foregoing findings of fact and opinion which are made a part of the judgment herein, the court concludes as a matter of law that

a. The following claims are valid and infringed and that defendant has no license thereunder:

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Patent No. 3,419,900, claims 4 and 7;
Patent No. 3,276,909, claim 9;
Patent No. 3,436,270, claims 1, 2, 3, 5–8, 10, 16, and 17.

b. The following claims are invalid:

Patent No. 3,436,270, claim 19;
Patent No. 3,553,024, claims 1, 3, 4, 6, and 11;
Patent No. 3,378,406, claims 1, 3, 8, and 9.

c. Claims 12, 15, and 16 of Patent No. 3,438,815 are not infringed by defendant.

d. Defendant is licensed under claims 1, 2, 3, 8, and 9 of Patent No. 3,531,327.

Accordingly, plaintiff is entitled to recover reasonable and entire compensation, the extent of which will be determined in further proceedings pursuant to Rule 131.

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530 F. 2d 911

HIGHWAY PRODUCTS, INC. v. THE UNITED STATES

[No. 48–73. Decided January 28, 1976]

ON PLAINTIFF'S MOTIONS FOR SUMMARY JUDGMENT AND TRIAL DE NOVO AND DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

Contracts; changes; equitable adjustment; defective and incomplete drawings and specifications; source information; reformation.—Plaintiff entered into a competitively negotiated, firm, fixed-price supply contract with the Department of the Army for 30 Hawk missile launchers. Prior to this procurement, a sole source had supplied the launchers, and since a specific purpose of the procurement was to obtain additional supply sources for the launcher and its components, source information was deleted from the drawings in the request for proposals (RFP) technical package. The package did not contain all the drawings and specifications listed on Exhibit A which accompanied both the RFP and the executed contract. Plaintiff was aware of such absence and of the illegibility of some of the documents, and although it made requests for supply of drawings and specifications, before submitting its bid it never made or attempted a complete and exhaustive analysis and identification of all the various drawings and specifications making up the RFP package. During a preaward survey, defendant warned plain-

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tiff that two complex and difficult components of the launcher had not been properly priced and that the amounts were considerably less than the amounts required in previous procurements. However, plaintiff confirmed its bid. A preaward conference at Redstone between representatives of the Government and plaintiff was held to try to resolve the drawing problems; plaintiff contends that at this meeting Government representatives indicated that they had no intention of seeing that plaintiff was hurt and that they would see that plaintiff was compensated for any changes made in the drawings and that these changes would be subject to negotiation. The contract was executed shortly thereafter. This case is before the court for review, pursuant to Wunderlich Act standards, of denial by the Armed Services Board of Contract Appeals of claims for additional costs allegedly incurred because the low bid and contract price resulted from the illegible and incomplete drawings and specifications accompanying the RFP package, which defects were not corrected until after bid confirmation. It is *held* that substantial evidence supports the board's conclusion that no separate agreement was made at Redstone to enlarge or modify the Changes article to compensate plaintiff for any drawing deficiencies or changes; that nothing in the record supports a finding that defendant's representatives agreed to compensate plaintiff for errors in underbidding on the two complex items; that plaintiff's failure to correct its bid and make further inquiry was an unreasonable assumption of risk; that plaintiff has not established that it was misled by the omission of source information in the preparation of its bid, nor that such omission created an ambiguity adding to its bid preparation problems; that plaintiff is not entitled to an equitable adjustment for changes resulting from the deficiencies in the RFP since it was within plaintiff's power, prior to execution of the contract, to have acquired the detailed knowledge requisite to an informed price, and its failure to eliminate the defects was unreasonable; and that reformation is inappropriate under the circumstances here. Plaintiff's motions are denied, defendant's cross-motion is allowed, and the petition is dismissed.

Contracts; interpretations; ambiguity.

[1] Where a provision of a contract is unclear and is capable of being interpreted in two reasonable ways, it is ambiguous.

Contracts ⇐ 143(2)

Contracts; interpretation; intention of parties to contract.

[2] Where there is an ambiguity in the contract instrument, it is appropriate to go outside the formal documents and ascertain the intent of the parties by examination of details of meetings and other materials in the contracting process.

Contracts ⇐ 169

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Contracts; changes; oral modification; effectiveness.

[3] A purported representation to plaintiff by Government representatives during a preaward meeting that plaintiff would be compensated for any changes because of failure of the Government to supply complete and legible drawings does not entitle plaintiff to an equitable adjustment for alleged additional work where the representatives were not authorized to enter a binding contract and where there is no indication that the representations went beyond the provisions of the Changes clause of the contract.

United States ⟸ 72(3)

Contracts; disputes; administrative decisions; substantial evidence; conflicting testimony.

[4] In Wunderlich Act review of an administrative decision, where the administrative board had an opportunity to observe the demeanor of witnesses, the court will accept the board's evaluation of credibility of conflicting testimony unless the testimony is inherently improbable or discredited by undisputed evidence of physical fact.

United States ⟸ 73(15)

Contracts; changes; source information.

[5] Where source information was blanked out on the drawings in the request for proposal package in order to develop additional supply sources for components of the end product and where the drawings in the package with the executed contract contained approved source information, absent evidence that the contractor was misled by the omission of source information in preparing its bid or that such omission created an ambiguity that added to its bid preparation difficulties, the subsequent addition of source information was not a change in the contractual relationship of the parties. An "approved" source is not the same as a "required" source or a "controlled" source.

United States ⟸ 72(5)

Contracts; interpretation; ambiguity; clarification, necessity for seeking.

[6] When a contractor is faced with an obvious omission, inconsistency or discrepancy of significance in an invitation for bids on a Government contract, he is obligated to bring the situation to the Government's attention if he intends subsequently to resolve the issue in his own favor. Here, prior to submitting its bid, reasonable conduct required that plaintiff check the schedule listing applicable drawings, specifications, etc., with the contents of the request for proposals technical package which would have uncovered deficiencies in the package. Under such circumstances, deficiencies in plaintiff's bid package do not involve the type of ambiguous contractual provisions that reasonably are subject to differing interpretations warranting application of the doctrine of *contra proferentem*.

United States ⟸ 70(3)

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Contracts; changes; equitable adjustment; defective specifications and drawings; costs of attempted compliance.

[7] Where at the time plaintiff signed the contract, it was aware that its bid was based upon incomplete information, it cannot complain when it knows of added costs and allows its bid to stand.

United States ⇐ 64

Contracts; interpretation; ambiguity; clarification, necessity for seeking.

[8] While potential contractors have a right to rely upon the sufficiency of a bid package, where plaintiff never, in the prebid stage, attempted a complete and exhaustive analysis and identification of the contents of the technical bid package by checking the contents with the schedule listing applicable drawings, specifications, etc., and did not seek clarification or make a written request for specific important missing materials needed to submit an accurate bid, its failure to eliminate the defects and to vigorously pursue the missing items was unreasonable.

United States ⇐ 64

Contracts; bids; confirmation of bid, Government request for.

[9] Where plaintiff, on a preaward survey, was placed on notice by the Government that two difficult components of the end product had been inadequately priced in its bid and the prior supplier was identified as well as the prices previously paid, plaintiff's confirmation of the bid without further inquiry was an unreasonable, unnecessary and unjustified assumption of risk.

United States ⇐ 64

Contracts; reformation; grounds for reformation.

[10] As a general rule, the Court of Claims has jurisiction in a Government contract controversy to provide the equitable relief of reformation as an incident to rendition of a money judgment, for instance, where there is an overreaching of a contractor by a contracting officer when the latter has knowledge, actual or imputed by the circumstances, that the bid is based on a serious mistake and, nonetheless, accepts the bid with that knowledge. However, where defendant warned plaintiff that a difficult component of the end product had been inadequately priced in its bid, plaintiff's confirmation of the bid manifests bad judgment for which reformation is not available.

United States ⇐ 72(1)

Contracts; reformation; mutual mistake of fact.

[11] A contract cannot be revised to reflect the subjective understanding of one party. A contract will not be reformed for mutual mistake unless a mutual mistake of material fact is clearly established on the record.

Reformation of Instruments ⇐ 19(1)

Timothy V. Dix, for plaintiff. *Richard E. Guster*, attorney of record. *Roetzel & Andress*, of counsel.

Russell W. Koskinen, with whom was *Assistant Attorney General Rex E. Lee*, for defendant.

Before SKELTON, NICHOLS, and KUNZIG, *Judges*.

PER CURIAM: This case comes before the court on plaintiff's request, filed May 8, 1975, for review by the court of the recommended decision of Trial Judge Kenneth R. Harkins, filed April 7, 1975, pursuant to Rule 166(c) on plaintiff's motion and defendant's cross-motion for summary judgment, wherein such facts as are necessary to the decision are set forth. The case has been submitted to the court on the briefs and oral argument of counsel. Since the court agrees with the recommended decision of the trial judge, as hereinafter set forth, it hereby affirms and adopts the said decision as the basis for its judgment in this case. Therefore, plaintiff is not entitled to recover, its motions for summary judgment and trial *de novo* are denied, defendant's cross-motion for summary judgment is granted and plaintiff's petition is dismissed.

OPINION OF TRIAL JUDGE

HARKINS, *Trial Judge:* This case stems from a competitively negotiated, firm, fixed-price supply contract with the Department of the Army for 30 Hawk missile launchers [1] and is before the court on cross-motions for summary judgment for review, pursuant to Wunderlich Act [2] standards, of nine claims denied by the Armed Services Board of Contract Appeals (ASBCA).[3]

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[1] Contract No. DA33-019-ORD-3972.

[2] 41 U.S.C. §§ 321-22 (1970).

[3] *Highway Products, Inc.*, ASBCA No. 10050, 68-2 BCA ¶ 7190. Plaintiff's motions are filed under Rules 101 and 163(b)(2), pursuant to order on July 27, 1973, that directed plaintiff, with respect to grounds for relief outside the contract, to file a motion for summary judgment or, in the alternative to list any contentions of fact that would require a trial de novo for resolution. Except as to evidence on damages, plaintiff relies upon the administrative record and does not want to submit further evidence on liability.

Opinion of Trial Judge

Plaintiff seeks $123,026.10 for additional costs allegedly incurred because its low bid and the contract price resulted from a defective body of technical information that accompanied the request for proposals (RFP), which defects were not corrected by defendant until after plaintiff's bid was confirmed. Plaintiff asserts five alternative grounds for relief:

> (1) Forty of the ASBCA's findings of fact are challenged as not supported by substantial evidence and seven of the ASBCA's conclusions as erroneous as a matter of law;
>
> (2) The supply of source information previously omitted in the RFP technical package was a compensable change in the circumstances of this case;
>
> (3) An express agreement entered concurrently with the execution of the contract would permit plaintiff to be compensated for performance requirements of which it was not aware when it submitted its bid;
>
> (4) Defendant's representatives overreached plaintiff by accepting a contract that they knew was based on defective drawings and specifications, as well as misinformation; and
>
> (5) Mistake of material fact rendered the written terms of the contract different from the contract intended by the parties.

For the reasons set forth below, the findings of the ASBCA are supported by substantial evidence, its conclusions are legally correct, and plaintiff's claims for relief outside the contract are not supported by the record.

The Hawk missile system had been developed by the United States Army Missile Command at Redstone Arsenal (Redstone), Alabama. Raytheon had been the prime contractor and a Division of Northrop Corporation had been the sole source subcontractor for Hawk missile launchers. About 700–800 Hawk missile launchers had been manufactured prior to plaintiff's contract, which was the first breakout for competitive procurement of the launcher. Plaintiff's management was experienced in Government procurement and familiar with Government contract principles. Plaintiff's president and chief executive officer, over a 21-year period, had held engineering or management positions with firms that had Government contracts in excess of $300,000,000.

On January 26, 1962, the Ordnance District in Cleveland (Cleveland Ordnance) solicited proposals for the launchers from 10 potential manufacturers, including plaintiff, Highway Products, Inc. The RFP consisted of the standard transmittal letter, which stated in part "[p]roposals should include a statement to the effect that you understand the requirements and can comply therewith," a schedule, a list of standard clauses, and an Exhibit A, which listed applicable drawings, applicable specifications, missile purchase descriptions (MPD's), and military and federal standards. The technical package called out in the RFP included approximately 2,400 drawings and totaled approximately 3,000 individual items.

Exhibit A to the RFP had been compiled at Redstone. Reproducible drawings, the MPD's, and design agency specifications were assembled at Redstone and furnished to the various procurement districts for reproduction. The various districts added the Army and Navy specifications (AN's), the joint Army and Navy specifications (JAN's), and other similar specifications, and put together the technical packages to accompany the RFP's. Since a specific purpose of the procurement breakout was to obtain additional supply sources for the launcher and its component parts, source information was deleted from the drawings in the RFP technical package.

Plaintiff's claims arise from deficiencies and discrepancies in the technical packages furnished by defendant from the documents that comprised the RFP and the executed contract. Exhibit A, in both the RFP documents and in the executed contract, was the same and referenced the same lists of drawings, specifications, MPD's, and other standards. The technical package that was delivered with the RFP differed from the package that was delivered in association with the executed contract. The RFP package did not contain all of the drawings and specifications listed on Exhibit A, nor did it contain all referenced but unlisted drawings and specifications, and many of the drawings that were furnished were illegible. After plaintiff had submitted its bid and by the time the contract was executed, or shortly there-

after, however, plaintiff had been furnished a complete technical package.

The record is not clear, and, in the circumstances, the board could make no finding that would specify the items that plaintiff received in the RFP technical package. Testimony of plaintiff's witnesses and defendant's witnesses as to the completeness of the RFP technical package is in conflict. Further, plaintiff's assertions as to the completeness of the RFP technical package differed during the course of the bidding and negotiating process. In addition, the record is not clear whether the technical package that was delivered in connection with execution of the contract consisted of the complete package that originally was supposed to be with the RFP, or whether it contained drawings that showed the changes that had taken place since the technical package had been frozen for the procurement, and which were the basis for negotiation of changes that ultimately were incorporated in contract Modification Nos. 1 and 8.

Plaintiff received the RFP technical package in early February 1962. Although plaintiff's examinations showed the technical package to be deficient, the board found that plaintiff, before it submitted its bid, "never made or attempted a complete and exhaustive analysis and identification of all of the various drawings and specifications making up the RFP package." [4] This finding is supported by substantial evidence.

On February 15, 1962, after preliminary telephone discussions with the contract administrator at Cleveland Ordnance about drawing problems, plaintiff submitted a list of 53 missing drawings, 18 unlisted but referenced drawings, and requested replacement of one illegible drawing. On February 20, 1962, during a visit to Redstone, plaintiff's contract administrator obtained all but nine of these 71 missing or unlisted drawings, and the nine remaining drawings were delivered subsequently by special delivery.

On February 22, 1962, plaintiff used the drawing problem as a basis for its request for a 2-week extension for submission of a proposal. Plaintiff's letter did not request other drawings and indicated that only a time extension was needed:

[4] 68-2 BCA at 33,363.

Some of these missing drawings turned out to be of such a nature that we could have scarcely submitted a reasonably accurate proposal without them, and most of the assembly drawings which were not included were the only means of determining quantities of components involved.

Inasmuch as we found it necessary to suspend some of our bidding analysis pending receipt of these missing drawings, and because of the complexity of determining component sources, we feel that an extension of the closing date is in order.

Plaintiff's request was granted. Plaintiff's proposal was submitted on March 20, 1962, without further mention of any drawing problem. Plaintiff's letter of transmittal recited "[w]e wish to state that we understand the requirements of this proposal and are capable of complying therewith."

On April 2, 1962, plaintiff amended its proposal to correct an arithmetical error in the analysis of special tooling costs. Plaintiff's letter discussed the drawing problem and indicated it had been solved.[5] As amended, plaintiff proposed a unit price of $28,647, with the total value of the contract at $863,910.

On April 9, 1962, during a preaward survey at plaintiff's plant, the Redstone representative warned plaintiff's administrator that two complex and difficult components of the launcher—the contact assembly and the axial piston pump—had not been properly priced and that the amounts plaintiff had allowed for procurement or manufacture were considerably less than the amounts required in previous procurements. Plaintiff's contract administrator was told the previous sources and the prices allowed for both the axial piston pump and the contact assembly. Notwithstanding this warning and information, plaintiff's management, on April 17, 1962, confirmed its bid, which was more than $4,000 less than the next higher bidder (who was found to be a nonresponsible

[5] The letter reads, in part, as follows:

"Although the condition of these drawings was unfortunate and delayed our estimating progress, we are of the opinion that their inclusion at this point would not change our bid estimate.

"In case we should be awarded this contract, we would, however, want to request at least one complete and legible set of drawings for engineering and production purposes."

bidder) and approximately $20,000 per unit less than the price quoted by the former sole source contractor.

Cleveland Ordnance, on April 24, 1962, notified plaintiff that it would probably receive the award and, on May 10, 1962, delivered the contract to plaintiff for signature. In the interim, plaintiff had tried to make up a bill of material, which effort was unsuccessful because of drawing deficiencies. On May 16, 1962, plaintiff notified Cleveland Ordnance that its examination of the Exhibit A, which was to be incorporated in the contract, showed it "had the same built-in deficiencies as the old" and that further examination showed there were "120 missing referenced drawings and 63 deficient, unreadable drawings." Plaintiff requested the following steps be taken before execution of the contract:

> 1. A new and complete set of drawings and drawing list, which will not require constant application for missing drawings, which result in interruptions of effort.
> 2. A revision to a more realistic delivery date in order to accomplish the above.
> 3. Agreement on the cost of contemplated changes to be incorporated in the original contract price.

Representatives of Cleveland Ordnance, Redstone, and plaintiff met at Redstone on May 22–23, 1962, to resolve the drawing problem. Plaintiff's representatives at Redstone had no authority to execute the contract. During this meeting, the conditions in plaintiff's May 16, 1962, letter were discussed and representatives of the Government "indicated that they had no intention of seeing that [plaintiff] was hurt and that they would see that they were compensated for any changes that were made in the drawings, and that these changes would be subject to negotiations." [6]

Plaintiff brought to the Redstone meeting a list of approximately 83 missing or defective drawings. A breakdown of the reproducing machine prevented delivery at the meeting of nine or 10 drawings, which were delivered subsequently on June 5, 1962. It was agreed at Redstone that negotiation of drawing changes that had taken place after the technical

[6] 68–2 BCA at 33,355.

package had been frozen for the procurement would not be made before the contract was executed.

On May 25, 1962, plaintiff transmitted the signed contract to Cleveland Ordnance with a letter of transmittal which stated:

> We are attaching herewith signed contract, covering Launcher, Zero Length, Guided Missile, sent to us with your letter of May 9, 1962, for execution.
>
> We are signing this contract with the following understanding:
>
> 1. Our proposal, dated 20 March 1962, was based upon the drawings and specifications made available to us in your Invitation No. RFQ M-1-86-2, dated 26 January 1962.
>
> 2. That Cleveland Ordnance District and AOMC recognize that the information on which our proposal was based is incomplete.

The legal office at Cleveland Ordnance advised the contracting officer that plaintiff's transmittal letter presented a serious question as to whether agreement had been reached by the parties, which question should be resolved before the Government executed the contract. On May 29, 1962, plaintiff's general sales manager was told by the Cleveland Ordnance contract administrator that the exceptions were unacceptable to the contracting officer. The Government representative recommended that the second sentence of the transmittal letter be deleted and suggested the following substitution therefor: " 'That any additions, deletions or changes to the drawings set forth in the original RFP will be subject to negotiation between Highway Products and the Government.[']"

A new transmittal letter dated May 29, 1962, with some alteration of the language suggested, was authorized by plaintiff's general sales manager by telegram. The new letter substituted the following as the last paragraph: "That any additions, deletions or changes will be subject to negotiations between our company and the Government."

On June 8, 1962, Cleveland Ordnance submitted an 11-page list of changes in the contract drawings and specifications as revised April 1, 1962, and requested plaintiff's price proposal therefor. Plaintiff, on August 16, 1962, proposed

a total time extension of 120 days, a unit price increase of $2,909.51 to a total of $31,556.51, and a total contract price increase to $946,695.30.[7]

Plaintiff's August 16, 1962, transmittal letter noted that "the list of drawings submitted with the bid request and later with the contract itself, contained many discrepancies, errors, and omissions," as a justification for its requested time extension. In this letter, plaintiff did not submit any price proposal for defects in the RFP technical package, nor did it give notice that claims for additional changes would be submitted subsequently. Plaintiff's letter indicated that there was only one other minor "area of possible price adjustment pending, in the form of inspection equipment, which we now find was not included in either the bid or contract lists."

Plaintiff's claims for defects in the RFP technical package that are involved in this case were not included in its August 16, 1962, proposal and were not presented to the contracting officer until January 10, 1964.

I.

Plaintiff contends that the May 22–23, 1962, meeting at Redstone and discussions about revision of the May 25, 1962, transmittal letter resulted in an express agreement to compensate plaintiff for performance costs of which it was not aware when it submitted its bid because of defects in the original RFP technical package. This contention has some support in the contract documents.

Plaintiff's contract in this case consists of the formal contract documents on DD Form 1261 and, in addition, the revised transmittal letter, dated May 29, 1962, that stated in paragraph 2 "That any additions, deletions or changes will be subject to negotiations between our company and the Government." Paragraph 1 of the revised transmittal letter identified the RFP technical package as the basis for plaintiff's March 20, 1962, bid and the content of paragraph 2 in that

[7] Modification No. 8, June 6, 1963, amended the contract to reflect price increases resulting from the June 8, 1962, changes. The unit price was increased to $31,456.51 and the total contract price was increased to $943,695.30. In a subsequent contract for 29 additional Hawk missile launchers, plaintiff was paid a unit price of $36,500.

context is not clear. Where a provision of a contract is unclear, and is capable of being interpreted in two reasonable ways, it is ambiguous.[8]

Where there is an ambiguity in the contract instrument, it is appropriate to go outside the formal documents and ascertain the intent of the parties by examination of the details of the May 22–23, 1962, Redstone meeting and other materials in the contracting process. The Redstone meeting was called for the purpose of trying to resolve plaintiff's drawing problem so that the contract either could be executed expeditiously or a new procurement initiated. Plaintiff's representatives at the Redstone meeting had no authority to enter a binding contract and were only authorized to obtain information and to make recommendations to plaintiff's management. No final agreement could have been made at Redstone. There is conflicting testimony in the record as to the content of the Redstone discussions. The board found that the discussions at the May 22–23, 1962, meeting at Redstone involved "nothing more than a full explanation of the 'Changes' clause of the proposed contract." [9]

The board heard testimony from representatives of each party and made its finding on the basis of the total record. The content of the discussions at the Redstone meeting is a question of fact determined by consideration of conflicting testimony where the trier of fact had the opportunity to observe the demeanor of witnesses. The board's evaluation of credibility is to be accepted unless the testimony is inherently improbable or discredited by undisputed evidence or physical fact.[10]

In addition to the conflicts of testimony as to whether defendant intended a concurrent separate agreement to compensate plaintiff for deficiencies in the RFP technical package, other circumstances militate against acceptance of plaintiff's meaning of the May 29, 1962, transmittal letter.

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[8] *Sun Shipbuilding & Dry Dock Co.* v. *United States*, 183 Ct. Cl. 358, 372, 393 F. 2d 807, 815 (1968); *Bennett* v. *United States*, 178 Ct. Cl. 61, 64, 371 F. 2d 859, 861 (1967).

[9] 68–2 BCA at 33, 365.

[10] *Koppers Co.* v. *United States*, 186 Ct. Cl. 142, 147 n. 7, 405 F. 2d 554, 558 n. 7 (1968), and cases there cited.

Plaintiff's original May 25, 1962, transmittal letter spelled out the agreement plaintiff says was intended. It would have established a basis for negotiation to compensate for deficiencies in the RFP technical package under an enlarged and modified Changes article. Defendant's contracting officer specifically refused to accept the contract as so modified. Defendant clearly did not contract on May 29, 1962, on the basis that plaintiff now asserts.

Further, if plaintiff believed it had a separate contract to negotiate changes to correct for deficiencies in the RFP technical package, it would have asserted these claims before January 10, 1964. The logical time to have asserted these claims would have been in the negotiations that followed defendant's June 8, 1962, request for a proposal on changes. Plaintiff, however, was silent on these claims in its August 16, 1962, response to defendant's 11-page list of changes and said nothing to reserve a right to submit these additional changes at a later date.

At the preaward survey on April 9, 1962, plaintiff was given notice that it had seriously underbid two high-priced components of the missile launcher—the axial piston pump and the contact assembly. Notwithstanding this warning, and with knowedge that manufacture of these two items was complex, plaintiff elected to stand on its bid. Nothing in the record would support a finding that defendant's representatives subsequently agreed to compensate plaintiff for errors it had made in its estimate for these two items. Plaintiff's April 17, 1962, confirmation letter, moreover, implied that mishandling of information in the technical package which resulted in "some miscalculation of the value of purchased parts" had been corrected.

Substantial evidence in the record supports the board's conclusion that no separate agreement was made to enlarge or modify the Changes article to compensate plaintiff for any drawing deficiencies or changes that were not encompassed in the June 8, 1962, 11-page list of changes. The portions of the transcript cited by plaintiff to support its contention have been reviewed. They do not warrant overturning the board's conclusion on this question of law.

II.

Three of plaintiff's claims (Nos. 1, 2, and 6) are based on the addition of source information to drawings after execution of the contract. Source information had been "blanked out" on drawings in the RFP technical package for the specific purpose of developing new procurement sources. Prior to award of the contract, plaintiff's requests for source information were denied because the information could not be given to one bidder without giving it to all potential bidders. The drawings in the technical package with the executed contract contained source information and Modification No. 7 on October 19, 1962, specifically noted that source notes on the drawings were not a restriction or limitation on procurement sources.

An "approved" source is not the same as a "required" source or a "controlled" source, and addition of source notes was not a change in the contractual relationship of the parties. Plaintiff has not established that prior to Modification No. 7 it was industry practice in the Cleveland procurement district for Government contractors to be limited in procurements to approved sources. The board found that plaintiff's chief executive officer, prior to the submission of its bid, knew that it was not required to purchase any components from the approved sources that later were added to the drawings.

Subsequent addition of source information did not change plaintiff's obligations under the contract. Further, it is not readily apparent how plaintiff would be able to show that the addition of source notes either would increase costs or increase the time required to perform the contract.

Plaintiff has not established that it was misled by the omission of source information in the preparation of its bid nor that the omission of source information created an ambiguity that added to its bid preparation difficulties. At most, the addition of source information after execution of the contract accelerated plaintiff's realization that it may have based its bid on procurements from sources that were more expensive than they otherwise might have been.

III.

Plaintiff also claims defects in the RFP technical package that involve omitted missile purchase descriptions, missing or illegible "find lists" on drawings, and omitted drawings are eligible for equitable adjustments under the Changes article. Unlike the addition of source information to drawings, plaintiff's remaining claims (Nos. 3, 4, 7, 8, 9, and 11, and parts of Nos. 1 and 6) involve constructive changes that are concerned with missing information and not with changed items.

In its consideration of this category of plaintiff's claims, the board allowed an equitable adjustment on two claims. In one (No. 5), plaintiff was allowed an adjustment where a missing MPD in fact was included neither on Exhibit A nor referred to in other documents in circumstances where, even if plaintiff had been diligent, there still should have been a gap that it could not reasonably be expected to detect. In the other (No. 10), the adjustment was allowed because certain drawings were either illegible or missing, defendant was aware that plaintiff lacked basic information and, from an examination of plaintiff's DD Form 633, defendant's representatives should have recognized another high-cost item had been seriously underbid. As in the case of the contact assembly and the axial piston pump, the board found that this situation was another in which defendant should have notified plaintiff that it had made a substantial underestimation of costs. In sum, the board has allowed equitable adjustments for plaintiff's claims in every instance where the board found that plaintiff reasonably could not have been expected to have done more to discharge its obligations with respect to missing information.

As to its remaining claims, plaintiff is eligible for an equitable adjustment only if it can show that its conduct in preparing its bid was reasonable. When a contractor is faced with an obvious omission, an inconsistency, or discrepancy of significance, he is obligated to bring the situation to the Government's attention if he intends subsequently to resolve the issue in his own favor.[11] In this case, although plaintiff knew,

[11] *Space Corp. v. United States*, 200 Ct. Cl. 1, 5, 470 F. 2d 536, 538 (1972).

or was in a position where it should have found out, that there were serious deficiencies in the RFP technical package, it did not resolve these matters before it submitted its bid. Reasonable conduct requires greater effort to clarify obvious and important deficiencies than that exerted by plaintiff.

The question of a contractor's duty to inquire or to take further action to remove deficiencies in bidding documents has been before the court in many cases. There is a duty to seek clarification of any obvious omission.[12] Defects in plaintiff's bid package did not involve the type of ambiguous contractual provisions that reasonably are subject to differing interpretations. The state of the RFP technical package does not involve the type of ambiguous contract provisions that would warrant application of the doctrine of contra proferentem.[13] Nor is this a case where the contractor was required to exercise clairvoyance and spot hidden ambiguities.[14] The deficiencies in the RFP technical package could have been uncovered by a mere checking of Exhibit A with the contents of the package. Plaintiff knew, or was in a position to know, what it had or did not have before it signed the contract.

Every drawing or specification relevant to plaintiff's remaining claims, except No. 9, was either included on Exhibit A or referred to in the documents that were included on Exhibit A. To the extent that any of the drawings plaintiff received were illegible, this deficiency could have been remedied by timely inquiry which, in fact, was done with respect to many drawings. In any event, as to these claims for a constructive change, it was at all times within plaintiff's power, prior to execution of the contract, to have acquired the detailed knowledge requisite to an informed price.

This is not a case where plaintiff had no notice of deficiencies before a contract was let. At the time plaintiff signed the contract, it was aware that its bid had been based

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[12] *Blount Bros. Constr. Co.* v. *United States*, 171 Ct. Cl. 478, 496, 346 F. 2d 962, 972 (1965).

[13] *Tecon Corp.* v. *United States*, 188 Ct. Cl. 15, 411 F. 2d 1262 (1969); *WPC Enterprises, Inc.* v. *United States*, 163 Ct. Cl. 1, 323 F. 2d 874 (1963); *Peter Kiewit Sons' Co.* v. *United States*, 109 Ct. Cl. 390 (1947).

[14] *Blount Bros. Constr. Co.* v. *United States*, *supra* note 12, 171 Ct. Cl. at 497, 346 F. 2d at 978.

upon incomplete information.[15] A contractor cannot complain when it knows of added costs and allows its bid to stand.[16]

Plaintiff contends that the board did not apply the proper standard to weigh the degree to which informational gaps in the RFP package were obvious. Plaintiff acknowledges that it knew certain drawings were missing and that certain lists were unreadable, but it concluded that any such deficiencies were not important to the preparation of a reasonably accurate bid. Plaintiff refers to expert testimony as to industry practice to work out reasonable bids from the materials received and cites the rule that contractors have a right to rely upon the sufficiency of the bid package. As the court noted in *Blount*,[17] contractors, as businessmen consciously seeking to underbid competitors, are usually pressed for time in the preparation of bids on Government contracts. As a result, they frequently only estimate costs which they feel the contract terms will permit the Government to insist upon in the way of performance. In this case, however, plaintiff did not establish what in fact was the condition of the RFP technical package. The board heard conflicting testimony and found that plaintiff never, in the prebid stage, attempted a complete and exhaustive analysis and identification of the contents of the RFP package. While failure to trace out each and every item in the package may be excusable, certainly plaintiff is required to resolve and seek clarification of missing materials that were needed to submit reasonable bids on major items. In these circumstances, plaintiff's failure to eliminate the defects was unreasonable.[18]

Exhibit A listed the MPD's that were supposed to be in the technical package. Plaintiff claims that the MPD's were not included and disputes the board's conclusion that they were included in the package that plaintiff received. There is no doubt that the MPD's were listed on Exhibit A, and,

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[15] *Whittaker Corp.* v. *United States*, 195 Ct. Cl. 161, 443 F. 2d 1373 (1971); *LaCrosse Garment Mfg. Co.* v. *United States*, 193 Ct. Cl. 168, 432 F. 2d 1377 (1970).

[16] *Dittmore-Freimuth Corp.* v. *United States*, 182 Ct. Cl. 507, 390 F. 2d 664 (1968).

[17] *Blount Bros. Constr. Co.* v. *United States*, *supra* note 12, 171 Ct. Cl. at 496, 346 F. 2d at 972.

[18] *Chris Berg, Inc.* v. *United States*, 197 Ct. Cl. 503, 514, 455 F. 2d 1037, 1044 (1972).

at the very least, were incorporated by reference in the RFP technical package. There can be no dispute that the MPD's were a part of the technical package plaintiff was to use in preparing a bid. The board found plaintiff had made no written request for specific MPD's prior to execution of the contract. In view of its engineers' repeated internal requests for MPD's, plaintiff's failure to vigorously pursue missing items of such importance is unreasonable. Plaintiff's contract administrator, at most, made only oral requests to Cleveland Ordnance, and these in very general terms, for missing MPD's, and made no followup to these oral requests.

One of plaintiff's remaining claims (No. 9, the contact assembly) is based on a missing schematic drawing which was neither included on Exhibit A nor referenced on any drawing. At the preaward survey, on April 9, 1962, however, plaintiff's attention was specifically drawn to its inadequate bid on this component, the previous source was disclosed, and the complexities of the assembly were emphasized. Although plaintiff had a week to reconsider, plaintiff made no request for further clarification before it confirmed its bid. Plaintiff, however, had the basic drawing, J9089117, Contact Assembly, Electrical, and had used it in discussions with the Redstone representative on April 9, 1962. Plaintiff's expert recognized the complexity of the assembly, as shown by the basic drawing, and should have known that such a complex item necessarily would require a schematic drawing. Plaintiff's failure to correct its bid on the contact assembly cannot be due to the omission of the schematic drawing. Plaintiff was aware of the prior source, as well as the price previously paid for this complex component, and nonetheless failed to make further inquiry. Reconfirmation of its bid, in these circumstances, was an unreasonable assumption of risk.

Two of the claims (Nos. 1 and 6) involve missing MPD's. Claim No. 1 concerned the axial piston pump, and the design control drawing in the RFP technical package referenced the MPD. As to this claim also, plaintiff was warned on April 9 that its price was abnormally low. The prior supplier was identified, as well as the price previously paid. Plaintiff nonetheless reconfirmed its bid. Absence of the MPD, which plaintiff could have obtained, if in fact it was not included

in the RFP technical package, could not have been the cause of plaintiff's low bid in these circumstances. In claim No. 6, MPD No. 7005A was referenced on Exhibit A and also on the related drawings. Plaintiff did not attempt to locate the MPD so that it could be used in solicitations from potential suppliers. Plaintiff recognized that this component would have to be purchased, but chose to estimate the probable cost of this complex item. Plaintiff's guess turned out to be too low; its assumption of this risk was unnecessary and unjustified. In solicitations for items, potential suppliers are expected to be provided the detailed information on specifications that is made available in a complex missile program.

The remaining five claims (Nos. 3, 4, 7, 8, and 11) all involve "find lists" (references to other drawings) that were either missing because the method of reproduction required the large "J" drawings to be done in two sections or were illegible on the drawing reproduction. There can be no excuse for not taking whatever action is necessary to obtain readable reproductions. With respect to each of these claims, plaintiff was in a position to clarify the situation and to obtain the correct information prior to submitting its bid. As to these items, plaintiff did not make any inquiry for the missing information until the May 22–23 meeting. Failure to pursue and correct such obvious deficiencies was unreasonable.

IV.

Plaintiff advances two additional grounds for relief, by reformation of the contract, that could not be made to the board. First, plaintiff contends that defendant's representatives knew that plaintiff's bid was in error because it was based on defective drawings and specifications and that execution of the contract, in such circumstances, constitutes an overreaching by defendant for which reformation is available. The second basis for reformation is an asserted mutual mistake of material fact. The circumstances of this case do not warrant reformation of the contract on either of plaintiff's theories.

As a general rule, this court has jurisdiction in a Government contract case to provide the equitable relief of

reformation as an incident to rendition of a money judgment.[19] The purpose of this remedy is to correct contractual instruments and make them conform to the clear intent of the parties. Reformation is in order only where there is a clear-cut clerical or arithmetical error or such a misreading of the contractual documents as to constitute an egregious blunder.[20] The court will reform a contract, by rescission or reformation, where there is an overreaching of a contractor by a contracting officer when the latter has knowledge, actual or imputed by the circumstances, that the bid is based on a serious mistake and, nonetheless, accepts the bid with that knowledge.[21] As evidence of defendant's overreaching, plaintiff cites the wide disparity between plaintiff's low bid and that of the next highest responsible bidder. On bid opening it was found that plaintiff had bid $28,647, and that the next responsible bid was for $43,527. The previous sole source supplier, who in 1962 had delivered 244 launchers at a unit price of $37,500, had bid $54,000 on this procurement. Such disparities, plaintiff asserts, are such to require defendant to be aware that plaintiff's inexperience was the cause of its unreasonably low bid.

On the facts of this case, defendant's awareness cannot amount to an overreaching for which reformation is appropriate. Defendant, in fact, did recognize the bid submitted by plaintiff was abnormally low. Because of this, defendant warned plaintiff that an obvious mistake had been made on two of the more complex items. Notwithstanding this warning, plaintiff did not withdraw and change its bid.[22] Plaintiff's reconfirmation of its bid, in the face of defendant's warnings, manifests bad judgment for which reformation is not available. Plaintiff assumed the risk of the consequences of its mistake.[23]

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[19] *Space Corp.* v. *United States*, *supra* note 11, 200 Ct. Cl. at 8, 470 F. 2d at 540; *California-Pacific Util. Co.* v. *United States*, 194 Ct. Cl. 703, 715 (1971).

[20] *Ruggiero* v. *United States*, 190 Ct. Cl. 327, 420 F. 2d 709 (1970); *Bromion, Inc.* v. *United States*, 188 Ct. Cl. 31, 411 F. 2d 1020 (1969).

[21] *Ruggiero* v. *United States*, *supra* note 20, 190 Ct. Cl. at 335, 420 F. 2d at 713.

[22] The board also has provided an equitable adjustment with respect to one item that the Government should have warned plaintiff about and which it failed to recognize.

[23] *Loral Corp.* v. *United States*, 193 Ct. Cl. 473, 434 F. 2d 1328 (1970).

Opinion of Trial Judge

Nothing in the record supports the contention that a mutual mistake of material fact existed at the time the contract was executed. An agreement cannot be revised to reflect the subjective understanding of one party.[24] No representative of the Government has been shown to have the concept of the contract that plaintiff now advances. Each of the Government's representatives testified that the May 29, 1962, revised transmittal letter, the language of which had been suggested by defendant, was only intended to define plaintiff's rights under the Changes article. Whatever plaintiff's intentions may have been with respect to future negotiations on deficiencies in the RFP technical package, there is nothing to support a finding that defendant's representatives so agreed. Mutual mistake of material fact must be clearly established on the record. Normally, such mistakes are limited to clear-cut clerical or arithmetical errors. The record would not support a finding that Government representatives manifested an intention to compensate plaintiff for errors it had made on bids for the axial piston pump or on the contact assembly, which had been the subject of specific warnings. The mutual mistake cases have no application to plaintiff's claims.

On the basis of the foregoing, plaintiff's motions are denied, defendant's cross-motion is allowed, and the petition is dismissed.

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[24] *Jamsar, Inc.* v. *United States*, 194 Ct. Cl. 819, 442 F. 2d 930 (1971).

ORDERS

No. 182–72. NOVEMBER 7, 1975

Henry L. Hinton

Military pay; reenlistment bonus; counterclaim for refund.—Pursuant to the order entered December 20, 1974, reported at 205 Ct. Cl. 882, concluding that the record evidence does not support plaintiff's claim that he was unlawfully discharged and ordering dismissal of the petition upon entry of judgment for defendant on its counterclaim, Senior Trial Judge Mastin G. White on remand filed a recommended decision concluding that in accordance with the provision of 37 U.S.C. § 308(e) defendant is entitled to recover that portion of the reenlistment bonus allocable to the unserved part of plaintiff's third enlistment. This case again came before the court on defendant's motion requesting that the court adopt said recommended decision. Plaintiff having filed no notice of intent to except thereto, upon consideration the court agreed with the recommended decision and on November 7, 1975 granted defendant's motion, adopted the recommended decision as the basis for its judgment in this case, entered judgment for defendant on its counterclaim against plaintiff for $281.62, and dismissed the petition.

No. 468–72. NOVEMBER 7, 1975

Patrick Michael O'Brien

Taxes; civil action for refund; claim pending before Tax Court.—On November 7, 1975 the court issued the following order:

Before DAVIS, *Judge*, Presiding, KASHIWA and KUNZIG, *Judges*.

"This case comes before the court on defendant's motion, filed June 30, 1975, for summary judgment. Upon considera-

tion thereof, together with the opposition thereto, without oral argument, it is concluded that under the established rule, plaintiff's suit in this court can be maintained only on those grounds fairly comprised in his refund claim filed with the Internal Revenue Service. The only ground for recovery which plaintiff set forth in his refund claim was that he did not owe the tax assessed because he did not have the income the Service thought he had. That is the precise issue which is now before the Tax Court, and under Section 7422(e) of the Internal Revenue Code this court has lost jurisdiction "to whatever extent jurisdiction is acquired by the Tax Court of the subject matter of taxpayer's suit for refund". It necessarily follows that this court no longer has jurisdiction of any part of plaintiff's case.

"IT IS THEREFORE ORDERED that defendant's said motion for summary judgment be and the same is granted and plaintiff's petition is dismissed."

No. 275–73. NOVEMBER 7, 1975

Montgomery Coca-Cola Bottling Company, Incorporated

Taxes; income tax; personal holding company.—On November 7, 1975 the court issued the following order:

Before DAVIS, *Judge*, Presiding, KASHIWA and KUNZIG, *Judges*.

"This case comes before the court on defendant's motion for summary judgment, filed July 21, 1975. This is a tax refund case in which plaintiff claims it was not a personal holding company under sections 541–543 of the Internal Revenue Code of 1954. This case has been previously argued and an order was entered, dated February 28, 1975, 206 Ct. Cl. 864, in which the court held for defendant on the threshold issue that some part of a 20-cent-per-gallon payment under a subbottling contract was a royalty. The court remanded to the trial judge for a factual determination of whether the amount of the gallonage payment attributable to the use of plaintiff's franchise was 5 cents or 20 cents per gallon.

"Defendant now argues that 20 cents per gallon should be accepted as a matter of law because it was set out in the

sub-bottling contract. Defendant cites *Commissioner* v. *Danielson*, 378 F. 2d 771 (3rd Cir. 1967), *cert. denied*, 389 U.S. 858 (1967). The *Danielson* rule is that taxpayers are bound for revenue purposes by an allocation of consideration in their contract. However, in this case plaintiff did not set out 20 cents per gallon as a royalty but incorporated the sub-bottling contract into the lease agreement and treated the total payment received as rent for the property, equipment, and franchise. Now that it has been determined that some part of the 20 cents must be considered a royalty, plaintiff is not bound as a matter of law by the recital of 20 cents per gallon to have the entire 20 cents considered to be a royalty.

"Defendant has raised this same argument also citing the *Danielson* rule in its supporting brief for its cross motion for summary judgment, filed on August 2, 1974. The court considered the briefs and made its order remanding the case to the trial judge for a factual determination. The argument was not upheld then and is not now.

"Upon consideration of defendant's motion for summary judgment, plaintiff's response thereto, and defendant's reply,

"IT IS ORDERED that defendant's motion for summary judgment be and is hereby denied."

No. 27–75. November 7, 1975

Richard J. Hoynes

Civilian pay; voluntariness of resignation; substantial evidence to support resignation; Internal Revenue employee.—Plaintiff, a former Internal Revenue criminal investigator, was arrested and charged with certain offenses. Subsequently and during discussions with his superiors, plaintiff was informed that in light of the circumstances surrounding the arrest and the sensitive nature of his position removal charges would be initiated; plaintiff was also informed that he had an option of resigning before removal was initiated and that if he did so, his personnel records would not reflect the initiation of adverse action procedures.

Plaintiff submitted his resignation, but later requested reinstatement claiming his resignation was involuntary. Following administrative denials of his request, plaintiff filed the present action. On November 7, 1975 the court issued the following order:

Before DAVIS, *Judge*, Presiding, KASHIWA and KUNZIG, *Judges*.

"This case comes before the court on defendant's motion, filed June 3, 1975, for summary judgment. Upon consideration thereof, together with the response in opposition thereto, without oral argument, it is concluded that a review of the administrative record and the established standards for appraising voluntariness demonstrate that the Civil Service Commission's determination that the plaintiff's resignation was voluntary was supported by substantial evidence and was in accordance with law. See *McGucken* v. *United States*, 187 Ct. Cl. 284, 288–89, 407 F.2d 1349, 1351–52, *cert. denied*, 396 U.S. 894 (1969), and *Leone* v. *United States*, 204 Ct. Cl. 334, 339–40 (1974).

"IT IS THEREFORE ORDERED that defendant's said motion for summary judgment be and the same is granted and plaintiff's petition is dismissed."

No. 35–75. NOVEMBER 7, 1975

Urban System Development Corp.

Court of Claims jurisdiction; declaratory relief; transfer to district court.—Plaintiff was low bidder on an Air Force construction project, being notified orally of the award and being furnished the contractual documents which it signed and submitted. Plaintiff sought to avoid performance of its obligations on the ground that no written notification of award was received within 60 days of bid opening. Upon defendant's insistence that a contract existed, plaintiff requested review by the Comptroller General who found that a contract had been formed. Plaintiff's appeal to the Armed Services Board of Contract Appeals was denied, 74–2 BCA para. 10,867. Plaintiff's petition requests judgment reversing the decision of the Board and determining that no con-

tract came into being between the parties. On November 7, 1975 the court issued the following order:

Before DAVIS, *Judge*, Presiding, KASHIWA and KUNZIG, *Judges*.

"Defendant's motion to dismiss on grounds that this court is without jurisdiction to render a declaratory judgment must be upheld. *United States* v. *King*, 395 U. S. 1 (1969); *Kirby* v. *United States*, 201 Ct. Cl. 527 (1973), *cert. denied*, 417 U. S. 919 (1974); *Austin* v. *United States*, 206 Ct. Cl. 719, *cert denied*, 423 U. S. 911 (1975); *Jankovic* v. *United States*, 204 Ct. Cl. 807 (1974). Plaintiff's petition is hereby dismissed.

"Plaintiff's request for a 90-day stay in order to allow it to obtain a deferred payment agreement with respect to its liability for excess procurement costs is denied on the grounds that this court should not continue actions in which we have no jurisdiction. If plaintiff perfects its action, it may file a new claim in this court. Furthermore, a deferred payment agreement is only discretionary with the Air Force.

"Plaintiff's request for transfer to the United States District Court for the District of Columbia pursuant to 28 U.S.C. § 1506 (1970) is denied. Plaintiff does not have a Tucker Act claim so a transfer to the District Court will be futile."

No. 47–75. NOVEMBER 7, 1975

Cagle Wholesale Lumber Co.

Contracts; Assignment of Claims Act; proper assignee.— The petition alleges that the Farmers Home Administration failed to honor assignments of construction progress payments made by the contractor to plaintiff. On November 7, 1975 the court issued the following order:

Before DAVIS, *Judge*, Presiding, KASHIWA and KUNZIG, *Judges*.

"This case comes before the court on defendant's motion, filed July 18, 1975, for summary judgment. Upon consideration thereof, together with the opposition thereto, without oral argument, it is concluded that the plaintiff obtained any claim prosecutable against the United States in this

court by assignment and that since the assignment to plaintiff is not within any exception to the sweeping prohibition of the assignment of claims against the United States, the plaintiff's claim is barred by the Assignment of Claims Act, 31 U.S.C. § 203. See *Uniroyal, Inc.* v. *United States*, 197 Ct. Cl. 258, 260, 454 F.2d 1394, 1395–96 (1972).

"IT IS THEREFORE ORDERED that defendant's said motion for summary judgment be and the same is granted and plaintiff's petition is dismissed."

No. 57–75. November 7, 1975

Peter Andrea Corp., Irving Engel and Jeremiah Kline

Court of Claims jurisdiction; Endangered Species Act of 1973; deprivation of right to engage in business; exception to Tort Claims procedure.—In Count I of the petition plaintiffs allege that the Endangered Species Act of 1973, 16 U.S.C. § 1531, *et seq.*, has deprived them of their right to engage in business transactions relating to skins of wild animals on the endangered species list without due process or compensation, causing them damages. In Count II plaintiffs allege that a federal employee interfered with negotiations for the sale of their stock in a Canadian corporation to a prospective purchaser, causing them damages. On November 7, 1975 the court issued the following order:

Before DAVIS, *Judge*, Presiding, KASHIWA and KUNZIG, *Judges*.

"Defendant's motion for summary judgment came before this court.

"We have fully considered the counter affidavit of David Goldstein, filed September 15, 1975, in this cause and defendant's brief filed in support of its motion for summary judgment. It appears that plaintiffs do not claim any actual taking of private property and this court does not have jurisdiction of the cause of action alleged in Count I under *Eastport Steamship Corp.* v. *United States*, 178 Ct. Cl. 599, 372 F. 2d 1002 (1967), and of the cause of action alleged in Count II under *Algonac Mfg. Co.* v. *United States*, 192 Ct. Cl. 649, 428 F. 2d 1241 (1970). However, due to a recent amendment to 28 U.S.C. § 2680 (Supp. IV, 1974) which

removes from the exceptions to the tort claims procedure abuse of process by investigative or law enforcement officers of the United States Government, plaintiffs may have such a claim here. Therefore, transfer of this case to the United States District Court for the Eastern District of New York under 28 U.S.C. § 1506 (1970) is appropriate.

"As to Count I, defendant's motion for summary judgment is hereby allowed and plaintiffs' petition is dismissed. As to Count II, defendant's motion for summary judgment is allowed on jurisdictional grounds and plaintiffs' petition is transferred to the United States District Court for the Eastern District of New York."

No. 313–75. NOVEMBER 7, 1975

Larry Michael Lane

Military pay; active duty pay claim; discharge; limitation of actions; appointment of counsel; motion to strike response.—On November 7, 1975 the court issued the following order:

Before DAVIS, *Judge*, Presiding, KASHIWA and KUNZIG, *Judges*.

"This military pay case *pro se* comes before the court on multiple motions: plaintiff's motion for appointment of counsel and for leave to have counsel amend his petition; plaintiff's second motion for appointment of counsel; plaintiff's motion to strike defendant's September 4, 1975 response; and defendant's motion to dismiss the claim as barred by the six year statute of limitations of 28 U.S.C. § 2501 (1970). We have carefully considered the various documents filed in support and in opposition.

"Plaintiff's claim discloses on its face that it is barred by the statute of limitations of section 2501. Plaintiff states that he was illegally discharged from the Army in August 1961, well over six years prior to his initiation of this action in 1975. A claim for active duty pay must be brought in this court within six years of the discharge date. *Kirby* v. *United States*, 201 Ct. Cl. 527, 531 (1973), *cert. denied*, 417 U.S. 919 (1974); *Webster* v. *United States*, 179 Ct. Cl. 917, 920 (1967). A claim based upon an illegal discharge is not, as plaintiff

suggests, a continuing claim, but rather "accrues all at once" upon the claimant's removal. *Mathis* v. *United States*, 183 Ct. Cl. 145, 147, 391 F.2d 938–39 (1968), *vacated on other grounds*, 183 Ct. Cl. 150, 394 F.2d 519 (1968), *petition dismissed*, 190 Ct. Cl. 925, 421 F.2d 703 (1970). Whatever the nature of plaintiff's discharge in 1961, the conclusion is inescapable that he in fact was separated from the military and had six years after that date to bring his claim here. Thus we are compelled to grant defendant's motion to dismiss.

"Our conclusions with regard to defendant's motion to dismiss also require the court to deny plaintiff's motions for appointment of counsel. First, we recognize that 28 U.S.C. § 1915(d) (1970) gives us the power to appoint counsel in civil cases. However, this section allows the court to appoint counsel when, *in its discretion*, it feels that appointment would be worthwhile. *U.S. ex rel. Gardner* v. *Madden*, 352 F.2d 792, 793–94 (9th Cir. 1965). For us to appoint counsel, we must be persuaded that plaintiff has a "compelling and meritorious" basis for recovery. *DeMaris* v. *United States*, 187 F. Supp. 273, 275 (S.D. Ind. 1960). Even by the most liberal construction of plaintiff's petition, it appears that the claim is barred by the statute of limitations. Thus, exercising our discretion, we hold that plaintiff's two motions for appointment of counsel must be denied along with the contingent request in the first motion to have counsel amend the petition.

"Finally, we further deny plaintiff's motion to strike defendant's September 4, 1975 response. Plaintiff suggests that we strike the response because it is redundant or because defendant submitted it before our ruling on plaintiff's other motions. Ct. Cl. Rule 52(e) which allows responses is not qualified by the limits plaintiff proposes. We must deny his motion to strike the response.

"Accordingly, upon consideration of the motions, the oppositions and replies, it is ORDERED that defendant's motion to dismiss be granted; that plaintiff's motion for appointment of counsel and for leave to have counsel amend the petition be denied; that the plaintiff's second motion for appointment of counsel be denied; and that plaintiff's motion to strike defendant's September 4, 1975 response be denied.

"The petition is dismissed."

On January 9, 1976 the court denied plaintiff's motion for rehearing. On June 25, 1976 the court denied plaintiff's motion for relief from judgment or order.

No. 421-73. NOVEMBER 14, 1975

Antranik Malajalian

Pleading and practice; failure to appear; non-resident plaintiff.—On November 14, 1975 the court issued the following order:

Before COWEN, *Chief Judge*, DURFEE, *Senior Judge*, DAVIS, SKELTON, KASHIWA, KUNZIG and BENNETT, *Judges*.

"This case comes before the court on a rule to show cause why plaintiff's petition should not be dismissed for his failure to comply with the court's order of March 14, 1975; reported at 206 Ct. Cl. 873. Plaintiff's attorney appeared in his behalf, made an urgent plea that plaintiff be given one final opportunity to appear at a hearing to be held not earlier than January 1, 1976, and gave the court certain assurances in the event his request should be granted. Defendant's attorney also appeared, furnished the court with information showing that instead of being in the French Foreign Legion, as plaintiff had advised the trial judge on September 29, 1975, plaintiff is now listed by the French Foreign Legion as a deserter. Defendant's attorney also stated that the Government had incurred a considerable amount of expense in complying with the court's order of March 14, 1975. Upon consideration of the requests and contentions of the attorneys for the parties, the court concludes that the order of March 14, 1975, should be amended as follows:

"Paragraph (2) thereof is amended by adding the following sentence:

> The trial judge shall fix the date for the hearing as soon after January 1, 1976, as he can conveniently do so, taking into account other cases which he has set for trial and similar commitments made by him.

"Paragraph (5) of the order is rescinded, and the following is substituted therefor:

> Plaintiff shall be required to bear the cost of his transportation and other expenses required for at-

tending the hearing without reimbursement by defendant. However, if plaintiff's attorney of record furnishes defendant's attorney of record with a statement as to where plaintiff resides in France or elsewhere, the attorney for defendant shall inform plaintiff's counsel, at a time to be fixed by the trial judge, when and where plaintiff can obtain a visa authorizing his entrance into the United States for the purpose of appearing and testifying at the hearing.

"IT IS FURTHER ORDERED that if plaintiff fails to comply with the order of March 14, 1975, as herein amended, plaintiff's petition may be dismissed without the issuance of a rule to show cause or other notice."

On March 19, 1976 the court dismissed the petition on the basis of information furnished by counsel that plaintiff would not be present at the hearing which the trial judge set for January 8, 1976.

No. 827–71. NOVEMBER 21, 1975 AND JANUARY 30, 1976

Maria Louisa Balli Allen, et al.

Pleading and practice; failure to prosecute and/or noncompliance with Rules and Orders.—On November 21, 1975 and January 30, 1976 the court issued the following orders:

Before COWEN, *Chief Judge*, SKELTON and BENNETT, *Judges.*

"This case, previously the subject of a court order, dated September 12, 1973, 202 Ct. Cl. 1114, is now before the court on 15 motions by defendant United States and certain third-party defendants. Six motions seek the sanction of dismissal of named plaintiffs under Rule 102(b) for failure to prosecute and noncompliance with rules and orders of the court and Rule 76(b)(3) for failure to comply with orders authorizing and requiring discovery by response to written interrogatories no later than January 15, 1975. Four motions seek imposition of the same sanction for the same reason for plaintiffs' failure to comply with an order requiring other answers by September 15, 1975. Five other motions filed by various third-party defendants against defendant United States, seek summary judgment in respect of the contingent cross-claim of the United States now pending against the movants. Many of the plaintiffs are in total default, having made no responses to the pending motions within the time

allowed by the Rules. Upon consideration thereof, and without oral argument, the court is satisfied that the failure of some plaintiffs timely to respond to the interrogatories is patently willful and that no mitigating circumstances have been shown to justify any further extension of time for answers first required by an order of December 12, 1973, and later the subject of many other motions and orders which have only been partly productive in moving along this case, which was filed in 1971. Defaults of plaintiffs have materially prejudiced defendants in their defense of these claims in that it has barred them from relevant information necessary to resolve the issues remaining for trial.

"IT IS THEREFORE ORDERED that the motions to dismiss certain named plaintiffs pursuant to Rules 102(b) and 76(b)(3) are allowed to the extent that all plaintiffs are dismissed under motions filed February 24, 1975, March 25, 1975, April 2, 1975, May 20, 1975, August 15, 1975, and October 6, 1975, who did not within 5 days (Rule 25(c)) after January 15, 1975, file their personal and individual answers to the 11 interrogatories propounded by defendant United States and first allowed by order on December 12, 1973, subsequently amended. The court believes on the uncontested information before it that 74 plaintiffs did not respond to the interrogatories at all, three responded well after January 20, 1975, and one did not sign or swear to her answers under oath as required by Rule 73(b). These 78 plaintiffs are dismissed, as follows:

Plaintiffs Nos.:

2	29	47	66	96
6	32	48	67	97
12	33	49	68	98
13	34	50	70	99
14	35	51	75	100
16	36	52	76	101
17	37	53	77	102
18	38	54	80	103
19	39	56	82	104
20	40	57	88	105
21	41	58	89	106
22	42	59	90	107
23	43	61	92	108
24	44	62	93	109
27	45	64	94	
28	46	65	95	

"Of the remaining 31 plaintiffs, 21 answered on or before January 15, 1975, and 10 within the 5 days allowable thereafter by Rule 25(c). These 31 plaintiffs are held to be in compliance and the six motions shown above are denied as to the following:

Plaintiffs Nos.:

1	10	55	74	86
3	11	60	78	87
4	15	63	79	91
5	25	69	81	
7	26	71	83	
8	30	72	84	
9	31	73	85	

"IT IS FURTHER ORDERED that the foregoing paragraph be, however, modified by the court's consideration of further motions for dismissal filed October 3, 6, 14 and 17, 1975, by third-party defendant Virginia Jones Mullin and others, who move for dismissal of 16 plaintiffs who failed under Rules 102(b) and 76(b)(3) to prosecute this action by willfully not responding to the interrogatories of said Mullin. The court allowed the interrogatories by order of July 8, 1975, and later by order of September 4, 1975, plaintiffs were granted their request for an extension of time to September 15, 1975, to answer "provided no further extension of time shall be granted." They have not answered or shown to the court any reason for not having done so and have not opposed the pending motion to dismiss them. Therefore, it being shown to the court's satisfaction that movants are materially prejudiced by their default, IT IS ORDERED that the motion be granted and the following plaintiffs are also dismissed:

Plaintiffs Nos.:

1	15	69	74
3	25	71	78
4	30	72	79
5	55	73	87

"Pursuant to this order, the only plaintiffs remaining in this case—all others having been dismissed—are the following:

Plaintiffs Nos.:

7	11	63	85
8	26	81	86
9	31	83	91
10	60	84	

"IT IS FURTHER ORDERED that in consideration of the motions filed May 13, 1975, July 7, 1975, July 31, 1975, August 15, 1975, and October 6, 1975, by third-party defendants to dismiss the contingent cross-claim of defendant United States, it is concluded that ruling thereon shall be and it is deferred until such time as the merits of plaintiffs' claims against defendant United States are finally determined."

"This case is before us once again upon a series of motions seeking the sanction of dismissal under Rules 76(b)(3) and 102(b) for failure to prosecute and failure to comply with orders of the court authorizing and requiring answers to written interrogatories propounded to plaintiffs by defendant United States and various third-party defendants. By order of November 21, 1975, we allowed similar motions and entered dismissal as against all but 15 of the original 109 plaintiffs in this case. The seven motions now before us seek the same sanction as to all remaining plaintiffs.

"Under motions filed by certain third-party defendants on November 7, 24, and 28, 1975, it is found that the following plaintiffs failed entirely to file required answers to interrogatories first allowed by order dated July 8, 1975, as amended by an order dated September 4, 1975. As to these three motions the 13 plaintiffs listed below are in total default, having allowed the time for response to expire without filing any opposition whatever.

"IT IS HEREBY ORDERED that the said motions be allowed, and the following plaintiffs are dismissed:

Plaintiffs Nos.:

7	26	83
8	60	84
9	63	85
11	81	86
		91.

"The two plaintiffs remaining in the case are the object of four other motions for dismissal, filed December 4, December 11, 1975, (two motions filed this date), and January 16, 1976. Said motions recite that plaintiffs Nos. 10 and 31 did not sign or swear to the truth of answers to interrogatories filed by them in response to the court's order of December 12, 1973, as subsequently amended. We imposed the sanction of dismissal as to plaintiff No. 32 for this reason in our order dated November 21, 1975, and find that dismissal is the appropriate sanction as to plaintiffs Nos. 10 and 31. The failure of compliance with Rule 73(b) by these two plaintiffs was not previously brought to our attention.

"IT IS THEREFORE ORDERED that the motions filed December 4, 1975, December 11, 1975 (two motions) , and January 16, 1976, seeking dismissal on this ground be, and they are hereby allowed. In lieu of amending our order of November 21, 1975, as requested by movants, however, we hereby order dismissal of the petition as to the following plaintiffs:

Plaintiffs Nos. 10 and 31.

"All plaintiffs have now been dismissed pursuant to this order and our order of November 21, 1975. Consequently, the contingent cross-claim of defendant United States against various third-party defendants has become moot. In our earlier order we deferred ruling on such contingent cross-claim until such time as the merits of the principal action were finally determined. This now being the case,

"IT IS FURTHER ORDERED that in consideration of motions filed May 13, 1975, July 7, 1975, August 15, 1975, and October 6, 1975, by third-party defendants to dismiss the contingent cross-claim of defendant United States, the said motions be and they hereby are allowed on the ground that the contingent claim therein asserted has become moot. The contingent cross-claim of the United States is dismissed."

No. 30–74. NOVEMBER 21, 1975

Roberto E. and Edith M. Alonso

Taxes; deductions; net operating loss carryover; foreign expropriation loss; election to carry forward losses, necessity

for filing.—On November 21, 1975 the court issued the following order:

Before COWEN, *Chief Judge*, SKELTON and BENNETT, *Judges.*

"The plaintiffs in this case seek a refund of Federal income taxes for the years 1967, 1968, and 1969. They came to to United States from Cuba in 1960 and later became naturalized citizens. In 1961 the Cuban Government confiscated property belonging to them in Cuba in the amount of $37,000. The plaintiffs contend that they were entitled to carry forward this loss for a period of ten years from the year of this loss under Section 172 (b)(1)(D) and (b)(3)(C) of the Internal Revenue Code of 1954. This statute was later amended in 1971 allowing a carryforward of losses of this kind for fifteen years.

"Treasury Regulation Section 1.172–11 required anyone claiming a foreign expropriation loss after December 31, 1958 and before January 1, 1964, to file an election for a carryforward of such losses with the District Director of the Internal Revenue Service for the district where the taxpayer filed his income tax return for the year of such loss on or before December 31, 1965. In this case the plaintiffs think that they filed such an election, but they cannot remember whether they did so in fact, nor can they find a copy of it. The District Director has no record of any such election having been filed.

"The Government has filed a motion for summary judgment which has not been answered by the plaintiffs. The Government bases its motion on two grounds as follows:

"(1) The plaintiffs cannot recover the taxes for the years in question because they did not file an election to carry forward the Cuban losses as required by the statute and the Treasury Regulation.

"(2) Even if the plaintiffs did file such an election, they still cannot recover because if the Cuban loss is offset against the plaintiffs' income in 1961, and the balance of the loss carried forward and offset against income for the years 1962 through 1966, the total loss of $37,000 was exhausted with the year 1966. Consequently, no recovery can be allowed

for the years 1967, 1968, and 1969, because there was no Cuban loss left to be carried forward to those years.

"We conclude that the Government's position is correct and that the plaintiffs are not entitled to recover whether they filed such an election or not.

"Accordingly, the defendant's motion for summary judgment is allowed and plaintiffs' petition is dismissed."

No. 291–74. NOVEMBER 21, 1975

Joseph Danunas Denis

Contracts; sale; installment contract obligation; "as is" sale.—On November 21, 1975 the court issued the following order:

Before COWEN, *Chief Judge*, SKELTON and BENNETT, *Judges*.

"This case is before the court on defendant's motion for summary judgment. Plaintiff, acting *pro se*, has not opposed the motion. In its petition, plaintiff seeks damages in the amount of $17,540 as a consequence of defendant's alleged breach of warranty in the sale to plaintiff of a residence, located in Little Falls, New York, and owned by the Veterans' Administration. Defendant contends that the subject residence was publicly listed and offered for sale to plaintiff in its 'as is' condition. By reason of plaintiff's alleged default, defendant counterclaims for expenses and damages in the amount of $1,542.31, but has offered to withdraw this counterclaim if its motion is granted. Defendant's motion for summary judgment is supported by an affidavit and documentary evidence which, in the absence of counter affidavits and documentary evidence submitted by plaintiff, is sufficient to establish the following facts:

"On April 9, 1969, the VA Sales Listing publicly listed the subject property at 36 Salisbury Street, Little Falls, New York, for sale "as is" at a price of $7,000. Although earlier listings thereof, at higher prices, had omitted the phrase 'as is,' plaintiff responded to the later listing and, on April 29, 1969, offered $6,500 for the property and signed a Credit Statement and Offer of Sale. The following italicized sen-

tence appeared directly above plaintiff's signature on the statement:

> I have examined the property and agree to accept same in its present 'as is' condition, and further agree that VA makes no warranties, expressed or implied, with respect thereto.

The statement was accepted by the VA on May 22, 1969. On June 9, 1969, plaintiff executed an Installment Contract of Sale (issued in lieu of a deed, since plaintiff was unable to make a 10-percent down payment), Paragraph 14 of which stated that:

> Delivery to and acceptance of this Agreement * * * shall constitute an acknowledgment by the Buyer that he has examined the property and is satisfied with its condition, and Buyer waives and releases forever any rights or claims against the Seller for performance by Seller of any further work upon the said premises.

"Plaintiff thereafter made six monthly payments of $90 and continued in possession of the property through December 1969. On January 25, 1970, plaintiff notified the VA that:

> I am returning the house to your possession as soon as you can arrange with the requirements. The house is unacceptable, as presented initially and with subsequent developments.

Despite written notice from the VA, dated January 28, 1970, that plaintiff could not unilaterally cancel his installment contract obligation, plaintiff made no further payments after December 1969 and, on June 9, 1970, the contract was terminated. After dismissal without prejudice of plaintiff's suit for $34,500 in damages brought in the Southern District of New York (July 25, 1973), denial of plaintiff's claim for one million dollars by the VA (January 9, 1974), and dismissal without prejudice of plaintiff's suit for one million dollars in the Northern District of New York (June 12, 1974), plaintiff filed suit in this court on the same facts alleged in the prior litigation.

"On the basis of the foregoing, the court concludes that in the sale of the subject property to plaintiff, the Government disclaimed any warranties, express or implied, and

that on the basis of many decisions of this court, plaintiff is not entitled to recover. *Rochester Iron & Metal Co.* v. *United States*, 168 Ct. Cl. 422, 427, 339 F. 2d 640, 643 (1964); *Montreal Securities, Inc.* v. *United States*, 165 Ct. Cl. 120, 124–25, 329 F. 2d 956, 958–59, *cert. denied*, 379 U.S. 826 (1964). The Government is not charged with any affirmative misstatement of fact. Plaintiff freely and knowingly contracted to purchase a house "as is", and he duly received the same. The very nature of the contract served notice that it was plaintiff's duty to inspect the property before accepting it and the risk of possible loss fell exclusively on him.

"IT IS THEREFORE ORDERED that defendant's motion for summary judgment is granted and plaintiff's petition is hereby dismissed.

"The defendant in its motion has stated that it will voluntarily dismiss its counterclaim against plaintiff in the amount of $1,542.31 if its motion for summary judgment is granted. Since we have granted the motion for summary judgment, we accept the defendant's statement as its motion to dismiss the counterclaim. Accordingly, the motion is granted, and the counterclaim is dismissed."

No. 329–74. NOVEMBER 21, 1975

Dan Bartos

Court of Claims jurisdiction; loss of property; summary judgment, when appropriate.—On November 21, 1975 the court issued the following order:

Before COWEN, *Chief Judge*, SKELTON and BENNETT, *Judges*.

"This case comes before the court on defendant's motion for summary judgment and several motions and papers filed by plaintiff, which will be treated as his cross-motion for summary judgment since plaintiff is a layman and represents himself. Upon consideration of the motions and other papers, the court finds as follows:

"(1) On January 1, 1964, the Forest Service of the Department of Agriculture issued a Special Use Permit to Ray Wagoner, authorizing him to operate a commercial resort,

known as the Pena Blanca Lake Resort, in the Coronado National Forest in Arizona. On March 25, 1969, Wagoner and wife entered into a conditional sales contract with plaintiff and his wife for the sale and purchase of the seller's lease and improvements at the resort.

"(2) On March 24, 1969, plaintiff applied for a Special Use Permit, and after he had submitted certain information requested, the permit was denied by Clyde W. Doran, Forest Supervisor of the Coronado National Forest, for the reasons set forth in a letter sent by certified mail on May 28, 1969. On June 11, 1969, the resort was closed to all public use.

"(3) Plaintiff continued in possession of the resort, and on June 16, 1969, the Government filed an action in the United States District Court for the District of Arizona, seeking to restrain him from occupying the property. Plaintiff vacated the resort on August 2, 1969, and thereafter, on August 27, 1969, the court granted the Government's motion to dismiss the suit.

"(4) On October 9, 1969, plaintiff requested Government forms for use in filing a claim for damages under the Federal Tort Claims Act, and the forms were submitted to him at that time. Nearly 4 years later, on August 13, 1973, he informed the Government that he had filed a claim for damages under the Federal Tort Claims Act in October 1969, and was then advised that no Federal agency had ever received it. On December 6, 1973, he filed a claim for damages in the amount of $130,000 against the United States under the Federal Tort Claims Act, and on August 24, 1974, the claim was denied by the Forest Service.

"Although plaintiff's pleadings are far from being clear, it appears that the gist of his claim is that the Government agreed to pay him $130,000 if he would refrain from taking criminal proceedings against employees of the Forest Service 'for their acts of other than authority to act, and by their wrongful act and omission of concealment of documents which was submitted to the Government.' Plaintiff also claims that 'settlement was made and agreed upon by plaintiff, cash from the office of the Department of Treasury, Mr. John B. Connally * * *,' and he alleges that this settlement occurred in August 1969. These claims are challenged

by two affidavits submitted with defendant's motion. The first is by Rubin Salter, Jr., the Assistant United States Attorney, who represented the Government in the action in the District Court. He denied unequivocally that he or any other attorney who represented the United States ever entered into any agreement or settlement with plaintiff or any representative of his whereby the Government agreed to pay him anything in settlements of any claims he may have had against the United States. The second is by Clyde W. Doran, Forest Supervisor of the Coronado National Forest, who states categorically that neither he nor any of his employees ever agreed, promised, or consented to pay plaintiff $130,000 or any other sum for the settlement of any claim which he may have had against the United States or any of its officers or employees.

"Plaintiff has not, since the filing of defendant's motion for summary judgment, filed an affidavit or affidavits specifically setting forth facts contrary to the affidavits submitted by defendant. Accordingly, plaintiff's claim must fail to the extent that it rests upon an alleged agreement entered into with agents of the Government. See Rule 101.

"In addition to his claim based on an alleged agreement, plaintiff also refers to a letter which he received from the Forest Service, giving him a 'right to file suit for the above claim.' It appears that this reference is to the claim under the Federal Tort Claims Act, which was denied by the Forest Service. The denial contained a statement that, if the claimant was dissatisfied with the denial, he could file suit in an appropriate district court. To the extent that plaintiff is claiming damages for tortious acts on the part of officers or employees of the Government, his claim must be dismissed on the ground that this court has no jurisdiction. 28 U.S.C. § 1346(b) provides that the United States District Courts have exclusive jurisdiction of all civil actions against the Government 'for injury or loss of property * * * caused by the negligent or wrongful act or omission of any employee of the Government * * * .'

"In view of the foregoing, IT IS HEREBY ORDERED that defendant's motion for summary judgment is granted, plain-

tiff's cross-motion or motions are each denied and plaintiff's petition is hereby dismissed."

On January 9, 1976 the court denied plaintiff's motion for review. On March 22, 1976 plaintiff filed a petition for certiorari.

No. 333–74. NOVEMBER 21, 1975

James R. and Selma K. Lewis

Court of Claims jurisdiction; taxes; claims of fraud, conversion of taxpayer's books and records; prohibition of suit to restrain assessment or collection; premature suit; summary judgment, when appropriate.—On November 21, 1975 the court issued the following order:

Before COWEN, *Chief Judge*, SKELTON and BENNETT, *Judges*.

"In this tax refund case plaintiffs' papers show six claims for relief. Plaintiffs move for summary judgment as to (1) an alleged loss carryback amounting to $1,763.61, (2) 'overpaid tax liability' of $930.55, (3) punitive damages of $48,061.74, such figure being twice the amount of extra income generated by an audit of the taxpayers' books for their taxable year 1969, (4) compensation of $50,000 for the Government's failure to return certain of taxpayers' records after the above-referenced audit, (5) release of tax liens that may heretofore have been or hereafter may be imposed with respect to plaintiffs' tax liability for taxable years 1950–73, and (6) an order prohibiting the Internal Revenue Service from further examination of taxpayers' records for the same period. Plaintiffs have elected to prosecute their claims here without the assistance of counsel.

"The Government has responded with its opposition and cross-motion for partial summary judgment. Defendant concedes that plaintiffs should have a trial as to their loss carryback claim and as to the claim for overpaid tax liability of $930.55, but denies that plaintiffs have established their right to such elements of recovery as a matter of law. Regarding the remaining elements of plaintiffs' claimed entitlement, defendant cross-moves for summary judgment on jurisdictional grounds. Defendant contends, further, that there can be no recovery on any theory with respect to tax-

able year 1974, since this suit was instituted before the close of that year and therefore prior to the time allowed by section 6532(a), Int. Rev. Code of 1954.

"With respect to the claims of loss carryback and overpaid tax liability, plaintiffs' motion for summary judgment must fail. Where a party seeks summary judgment it must establish the absence of material issues of fact and demonstrate entitlement to judgment as a matter of law. Rule 101 (d); *Gernand* v. *United States*, 174 Ct. Cl. 936 (1966). The motion and supporting materials merely state these claims, and do not elaborate. Plaintiffs have not met their burden of proof in showing entitlement to summary judgment. *Adickes* v. *S. H. Kress & Co.*, 398 U.S. 144, 161 (1970). Accordingly, we are not authorized to enter summary judgment for plaintiffs. Taxpayers are entitled to have these elements of their case considered further by the trial judge, however, and the case must be remanded for that purpose to ascertain the facts.

"Turning to defendant's cross-motion for partial summary judgment, we first encounter two claims seeking recovery for alleged wrongful conduct of Internal Revenue Service officials. A request is made for punitive damages for 'criminal fraud' perpetrated by Government auditors, and compensation for the wrongful withholding of taxpayers' records. Congress has not given this court the power to decide such claims. We conclude that we have no jurisdiction inasmuch as they both sound in tort. 28 U.S.C. § 1491 (1970); *Myers* v. *United States*, 206 Ct. Cl. 863 (1975). We are powerless to award punitive damages. *Vincin* v. *United States*, 199 Ct. Cl. 762, 765, 468 F. 2d 930, 932 (1972). Moreover, we do not have the authority to determine a claim for conversion, such as the one now pressed by plaintiffs with respect to their books and records. *Algonac Mfg. Co.* v. *United States*, 192 Ct. Cl. 649, 663, 428 F. 2d 1241, 1249 (1970). Even if we were to view the claim for conversion of taxpayers' records as being based upon a contract implied in fact or on some other theory, it would be barred by the doctrine of res judicata. It is alleged and not denied that the identical cause of action was tried and determined adversely to taxpayers in other proceedings known as *Lewis*

v. *United States*, Civil Action No. CV 74–432–RJK (C.D. Cal. July 11, 1974), where the district judge, after trial of the issue, found as a fact that plaintiffs' records were returned to plaintiffs and thus not converted.

"In taxpayers' remaining claims they request dissipation of certain tax liens, and orders restraining IRS officials from further examination of their tax records with respect to taxable years 1950–73. We conclude that we have no jurisdiction to provide this kind of relief in a tax case. Section 7421(a), Int. Rev. Code of 1954, provides, in pertinent part:

> * * * no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed.

The Supreme Court of the United States has said that the purpose of this provision is—

> * * * to permit the United States to assess and collect taxes alleged to be due without judicial intervention, and to require that the legal right to the disputed sums be determined in a suit for refund. * * *. [*Enochs* v. *Williams Packing & Nav. Co.*, 370 U.S. 1, 7 (1962).]

The *Enochs* decision holds that the sole exception to the operation of section 7421(a) obtains where the assessment made by Government officials is so unwarranted in law as to be only '"the guise of a tax."' *Id.* Taxpayers have made no such showing here, and it is difficult to imagine a case which would more directly restrain the collection or assessment of taxes than that which the taxpayers now seek to prosecute. On these two elements of plaintiffs' case, the Government is entitled to a summary judgment on its cross-motion.

"Lastly, the Government adverts to section 6532(a) of the 1954 Code, saying that it erects a jurisdictional bar to consideration of any claim whatever relating to taxable year 1974:

> § 6532(a)(1).
>
> No suit * * * for the recovery of any internal revenue tax, * * *, shall be begun before the expiration of 6 months from the date of filing the claim [for refund] * * * unless the Secretary or his delegate renders a decision thereon within that time, * * *.

The record shows that the instant petition was filed on September 11, 1974—undoubtedly before any refund claim could have been filed in respect of taxes paid for 1974 income. We conclude that so far as 1974 is concerned, the case is prematurely filed. Section 6532(a) bars suits filed before the passing of the 6-month period—even where at the time the case comes on for hearing 6 months have passed since the date a refund claim was filed. *See, e.g., Harkins* v. *United States*, 18 AM. FED. TAX R.2d 5555 (E.D. Okla. 1966), *aff'd on other grounds*, 375 F. 2d 239 (10th Cir. 1967). Even if it be assumed, therefore, that plaintiffs filed a refund claim on the earliest possible date, the suit is barred as to 1974. Where a case is filed before the time allowed by section 6532(a), such claims as are barred thereunder should be dismissed without prejudice to the bringing of a new, timely action. *Woodard* v. *United States*, 232 F. Supp. 831 (E.D. Pa. 1964).

IT IS THEREFORE ORDERED, without oral argument, that the plaintiffs' motion for summary judgment is denied, and the defendant's cross-motion for partial summary judgment is allowed. As to the claims demanding punitive damages and damages for loss of personal property, the petition is dismissed. As to the requests for dissipation of liens and for an order restraining IRS officials from further investigation, the petition is likewise dismissed. As to taxable year 1974 with respect to the issues remaining for further consideration, the petition is dismissed without prejudice. The case is remanded to the trial division for further proceedings consistent with this order."

On January 30, 1976 plaintiffs' motion for rehearing and reconsideration was denied.

No. 2–75. NOVEMBER 21, 1975

Woodrow Yokum

Suit to recover value of property seized by Government; limitation of actions; accrual of cause of action; tolling of statute; prior criminal proceedings.—On November 21, 1975 the court issued the following order:

Before COWEN, *Chief Judge*, SKELTON and BENNETT, *Judges*.

"On January 2, 1975, plaintiff filed his petition herein to recover the sum of $400,000 alleged to be the reasonable value of property to which plaintiff claimed ownership and which was taken from him by the defendant during the months of February and March 1967. The case is before the court on defendant's motion for summary judgment and plaintiff's opposition thereto. Upon consideration of the motions and briefs of the parties, plus the affidavits and documentary exhibits supporting defendant's motion, the court finds:

"(1) Pursuant to a series of search warrants issued by the United States District Court for the Northern District of West Virginia, the defendant seized, possessed, and impounded a large quantity of the personal property which is the subject matter of this suit. The property consisted of automobiles, military trailers, trucks, electronic and radio equipment, military clothing, electric generating equipment, and other similar property. Each of the search warrants stated that the 'property was embezzled, stolen, purloined and converted from the said United States of America and then concealed and retained with intent to convert said [property] for personal use and gain, in violation of Title 18, Section 641, United States Code.'

"(2) Following the seizure of the property in 1967, two separate Federal actions were instituted against the plaintiff. The first, which was commenced in the Northern District of West Virginia, resulted in plaintiff's conviction on six counts of violating 18 U.S.C. § 2312 (interstate transportation of a stolen motor vehicle), one count of violating 18 U.S.C. § 2314 (transportation of stolen property in interstate commerce), and three counts of violating 18 U.S.C. § 641 (theft of Government property). The judgment and commitment order was entered on August 5, 1968. On appeal, the Fourth Circuit reversed the district court as to one count but affirmed plaintiff's conviction as to the remaining nine counts.

"(3) On February 24, 1970, plaintiff's petition for a writ of certiorari from the Fourth Circuit to the Supreme Court was denied, 397 U.S. 907, and the petition for rehearing was denied on April 6, 1970, 397 U.S. 1030.

"(4) On April 13, 1970, plaintiff filed a motion, pursuant to Rule 41(e) of the Federal Rules of Criminal Procedure, for the return of his property. On May 29, 1970, the United States District Court for the Northern District of West Virginia denied the motion without prejudice to plaintiff's right to prosecute a civil action for the return of the property and for the rental value of property seized.

"(5) The second criminal proceeding, commenced by indictment in the Eastern District of Virginia, was dismissed on July 9, 1970.

"(6) As shown by the affidavit of the United States Attorney, who handled the criminal proceedings in West Virginia, it was the position of the Government at all times after the seizure of the property that it belonged to the United States and would not be returned to plaintiff. The United States Attorney wrote plaintiff on May 22, 1972, to the effect that if he could produce evidence of ownership of any items of the property, it would be returned to him. The letter further stated, however, that since plaintiff refused to provide any information which would support his claim to possession, the Government was taking appropriate measures to dispose of the property. Plaintiff's petition also alleges in Paragraph 8 that 'The United States has exercised dominion and control of all of the property set forth in the aforedescribed Warrants continuously from the respective dates of the seizures to the present.' Although plaintiff has made some unsupported statements to the contrary in his pleadings, the foregoing facts are taken as established and uncontroverted. *Royal Indemnity Co.* v. *United States*, 178 Ct. Cl. 46, 52, 371 F. 2d 462, 465, *cert denied*, 389 U.S. 833 (1967); *Hartwig* v. *United States*, 202 Ct. Cl. 801, 810–11, 485 F.2d 615, 620–21 (1973).

"Defendant's motion for summary judgment is based on the ground that, since the alleged taking occurred not later than March 1967, plaintiff's petition became barred by the 6-year statute of limitations in 1973. *See* 28 U.S.C. § 2501.

"It is well settled that a cause of action for a Fifth Amendment taking accrues at the time the taking occurs, i.e., when the owner is deprived of the use and possession thereof. *Stafford Ordnance Corp.* v. *United States*, 123 Ct.

Cl. 787, 793, 108 F. Supp. 378, 381 (1952); *Steel Improvement & Forge Co.* v. *United States*, 174 Ct. Cl 24, 29–30, 355 F.2d 627, 631 (1966).

"In an effort to avoid the bar of the statute of limitations, plaintiff first contends that his cause of action did not accrue until April 6, 1970, when the Supreme Court denied his motion for rehearing on his petition for a writ of certiorari. This contention is rejected on the ground that a determination of the lawfulness of the search warrants under Fourth Amendment standards has no bearing on the question of the ownership of the property. *See Warden* v. *Hayden*, 387 U.S. 294 (1967).

"Plaintiff's second contention is that his cause of action accrued on May 29, 1970, when the district court denied his post trial motion, filed under Rule 41(e) of the Federal Rules of Criminal Procedure, for the return of his property. However, we find that a Rule 41(e) motion is designed to protect a defendant in a criminal case from the introduction into evidence of property which was wrongfully seized and that such a motion cannot be used as a post-conviction remedy for the return of the property. *See Bartlett* v. *United States*, 317 F.2d 71 (9th Cir.), *cert. denied*, 375 U.S. 847 (1963); *United States* v. *Butler*, 299 F. Supp. 778, 779 (D. Mass. 1969). As the district judge stated in his order of denial, plaintiff's proper remedy after conviction was a wholly independent civil action for the return of property he claims as his own.

"Plaintiff next contends that his cause of action accrued on July 9, 1970, when the United States District Court for for the Eastern District of Virginia dismissed the 31-count indictment against him. Alternatively, he says that the cause of action did not accrue until March 10, 1972. This was the date of the expiration of the 5-year statute of limitations upon which further criminal indictments could be returned against him. We find these contentions to be without merit. In the first place, the expiration of the criminal statute of limitations merely acts as a bar to prosecutions under the criminal laws and has no effect on whether the property is 'mere evidence' or 'fruits of a crime.' Moreover, we have repeatedly held that the pendency of criminal proceedings,

and even imprisonment, is not a legal disability which extends the time for filing suit in this court beyond the period specified in 28 U.S.C. § 2501. *See Grisham* v. *United States*, 183 Ct. Cl. 657, 664, 392 F.2d 980, 984, *cert. denied*, 393 U.S. 843 (1968); *Jackson* v. *United States*, 179 Ct. Cl. 29, 36, *cert. denied*, 389 U.S. 985 (1967); *O'Callahan* v. *United States*, 196 Ct. Cl. 556, 563, 451 F. 2d 1390, 1393 (1971).

"In view of the foregoing, the court concludes, as a matter of law, that plaintiff's suit is barred by the statute of limitations. IT IS THEREFORE ORDERED that defendant's motion for summary judgment is granted, and plaintiff's petition is dismissed."

On January 30, 1976 the court denied plaintiff's motion for rehearing and for further relief. On April 26, 1976 plaintiff filed a petition for certiorari.

No. 84–75. NOVEMBER 21, 1975

Stephen Blanchett, et al.

Civilian pay; crew members; prevailing rate systems; discretion of agency in setting wages; special project ship.—On November 21, 1975 the court issued the following order:

Before COWEN, *Chief Judge*, SKELTON and BENNETT, *Judges*.

"The plaintiffs in this case are civilian crew members aboard two tugboats, namely the U.S.N.S. Mosopelea and the U.S.N.S. Atakapa, operated by the Military Sealift Command (MSC), a component of the Department of the Navy. The plaintiffs sue for higher pay claiming that in fixing their pay in accordance with 5 U.S.C. § 5348 (1970), *as amended*, (Supp. II, 1972), the Navy has acted in an arbitrary and capricious manner and has refused to utilize the prevailing rates and practices for deep sea tugs in private industry. Section 5348(a) provides as follows:

> Except as provided by subsections (b) and (c) of this section, the pay of officers and members of crews of vessels excepted from chapter 51 of this title by section 5102(c)(8) of this title shall be fixed and adjusted from time to time as nearly as is consistent with the public interest in accordance with prevailing rates and practices in the maritime industry.

"After considerable study, in which the plaintiffs' Maritime Union was invited to participate, the MSC determined that there was no prevailing practice in the maritime industry which could be utilized as a basis for setting the wages of these civilian employees aboard these ocean tugs. Rather, the tugs were classified as 'special project ships' within the meaning of Civilian Marine Personnel Instruction (CMPI) 531, ¶2–1.K. A special project ship is therein defined as:

> A ship assigned to a mission other than the routine transportation of dry cargo, fuel and lubricants or passengers. Normally, civilian and/or military personnel are carried aboard ship, in addition to the regular crewmembers, to operate special equipment and gear, to serve as stevedores, or to perform some task related to the designated mission of the ship.

Application of the power tonnage formula utilized in the maritime industry resulted in the vessels being placed in Class E for pay purposes. The MSC found that the operations of the tugs in question were similar to other MSC special project ships and base the pay of their crews on that of Class E ocean going passenger and dry cargo ships which meet the requirements of law and was in the public interest. No counterpart to the tugs was found by MSC to exist in private industry. The plaintiffs contend that they should receive the same pay as the crews of tugboats operating in and around the port of New York. The MSC rejected this contention based on the facts that such other tugboats are not involved in deep sea operations and their personnel are not subject to the same stringent licensing requirements which are applied to the tugboats in question. Furthermore, the high rates of pay received by the crew members of local tugboats could be attributable to the part-time nature of harbor tug work as an inducement to obtain personnel when necessary.

"Consideration was also given by MSC to ocean going commercial tugboats, but again found there was a substantial difference between them and the tugboats in question. It was found that the commercial tugs have a normal crew of only nine to ten men, whereas the tugboats here have crews that are much larger. Furthermore, the commercial tugs operate in remote areas such as the Arctic and the Aleutians and

their slow speed of travel require their being as sea for long periods of time. Salary inducements are considered necessary to attract personnel. This is not the case however with the tugs in question which have a larger work force, mess men to provide sit-down meal service (there are no mess men on the commercial vessels) library and movie facilities, and exchange privileges, all of which relieve the monotony of a long sea voyage but none of which are available on commercial tugboats. Finally, it was found that the tugs in question actually had no real counterpart in private industry, because no industry vessel performed the variety of tasks performed by the tugboats here.

"The plaintiffs appealed from the MSC decision through the national Maritime Union of America (NMU) to which they belong, and requested a review by the Department of the Navy's Office of Civilian Manpower Management (OCMM). On November 21, 1974, OCMM advised the NMU that the MSC decision to treat the tugs as special project ships and to base the pay of their crews on that of Class E ocean going passenger and dry cargo ships was correct, met the requirements of law, and was in the public interest. The plaintiffs then filed this suit.

"The case is before us on defendant's motion for summary judgment which is supported by affidavits filed by the defendant. The plaintiffs contest defendant's motion for summary judgment alleging that there are unresolved material questions of fact which require a trial. The plaintiffs frankly admit that they 'are not in a position to set forth sufficient facts in an affidavit to justify opposition to the motion for summary judgment.' They desire to participate in discovery proceedings on the theory that evidence may be discovered which supports their position.

"It apears that the plaintiffs have not stated a cause of action on which relief can be granted by showing that the decision of the Navy in fixing their pay was arbitrary and capricious, nor that the law requires their wages to be fixed at the same rates paid to crew members of local tugs or of deep sea tugs in private industry. Neither have they shown that the decision of the Navy is not supported by substantial evidence, nor that it is so arbitrary as to be clearly wrong.

"This court has held many times that the Government has broad discretion in fixing pay under section 5348. *See Blaha* v. *United States*, 206 Ct. Cl. 183, 189, 511 F.2d 1165, 1167 (1975); *Benevento* v. *United States*, 198 Ct. Cl. 772, 777–78, 461 F.2d 1316, 1320, *cert. denied*, 409 U.S. 1038 (1972); *Daniels* v. *United States*, 187 Ct. Cl. 38, 41, 407 F.2d 1345, 1347 (1969); *Ayres* v. *United States*, 186 Ct. Cl. 350, 359–60 (1968); and *Amell* v. *United States*, 182 Ct. Cl. 604, 390 F.2d 880, *cert. denied*, 393 U.S. 852 (1968). In *Benevento*, the court, in citing the Daniels case stated that the statute 'embodies a broad congressional grant of administrative discretion, with a concomitant limited scope of judicial review. "Our concern, * * * is simply to determine whether plaintiffs have met their heavy burden of proving that the Secretary's action in this instance was so arbitrary as to be clearly wrong.' "

"We conclude from the foregoing facts and authorities that the Navy's decision was a correct one and was supported by substantial evidence. The plaintiffs have not shown any facts or authorities upon which we could hold that the Navy's decision was so arbitrary as to be clearly wrong. Under these circumstances, it is not necessary to have discovery proceedings or a trial.

"IT IS THEREFORE ORDERED that defendant's motion for summary judgment be granted and plaintiff's petition dismissed."

No. 139–75. NOVEMBER 21, 1975

Trus Joist Corporation

Contracts; implied-in-fact-contract; third-party beneficiary; authority of Government agents.—On November 21, 1975 the court issued the following order:

Before COWEN, *Chief Judge*, SKELTON and BENNETT, *Judges*.

"This case is before the court on defendant's motion to dismiss the petition. Plaintiff, a Nevada corporation with its principal place of business in California, contracted in November 1973 with the Navajo Housing and Development Corporation (NHDC), a wholly-owned subsidiary of the Navajo Nation, to manufacture and supply trus joists for

use in construction of a Navajo professional building in Window Rock, Arizona. Not having received payment for the joists delivered, plaintiff sues the United States to recover the value thereof, in the approximate amount of $41,000.

"Each of plaintiff's two alternative claims is predicated upon the alleged existence of an implied-in-fact contract to which defendant was a party. The first claim alleges formation of such a contract between defendant and the NHDC on the basis of either defendant's 'approval' of the Navajo building project, or defendant's relationship with the Navajo Nation generally. Plaintiff asserts that it is entitled to recover as an intended third-party beneficiary of such contract. We conclude that defendant's motion to dismiss must be granted as to the first claim of the petition because, in order for a contract implied in fact to exist, there must be a meeting of the minds and a mutual consent to be bound. *Operational Manuals, Inc.* v. *United States*, 205 Ct. Cl. 854, 855 (1974); *Somali Development Bank* v. *United States*, 205 Ct. Cl. 741, 751, 508 F.2d 817, 822 (1974).

"The first claim of plaintiff's petition contains neither of these two essential allegations. Instead, plaintiff argues that the Government's approval of the Navajo building project created a contract implied in fact which obligated the Government to pay any debts incurred in the construction of the project. However, mere approval of the project does not show that the Government consented to be contractually bound. *See United States* v. *Algoma Lumber Co.*, 305 U.S. 415, 421 (1939); *McCalib* v. *United States*, 83 Ct. Cl. 79, 85 (1936) and *D. R. Smalley & Sons, Inc.* v. *United States*, 178 Ct. Cl. 593, 597–98, 372 F.2d 505, 507–08, *cert. denied*, 389 U.S. 835 (1967).

"Plaintiff cannot recover as a third-party beneficiary of a contract, because there is no allegation in its petition of the existence of any contract between the Government and the Navajo Housing and Development Corp., which contains a promise or obligation by the Government, which was not fulfilled. *Housing Corporation of America* v. *United States*, 199 Ct. Cl. 705, 710, 468 F.2d 922, 924 (1972).

"Plaintiff's second claim alleges that prior to the shipment and fabrication of materials supplied by plaintiff, the Indian Financing Act of 1974 was enacted and that plaintiff was

assured by representatives of the Government that, because of this act, plaintiff would be paid for the material. Plaintiff's second claim is defective in that it does not specify the names or position of the Government officials who made such representations nor does it contain any allegation that they were authorized to so obligate the Government. Such allegations are prerequisite to this court's exercise of jurisdiction over claims founded upon contracts, whether express or implied. *See Operational Manuals, Inc.* v. *United States*, 205 Ct. Cl. at 856; *Housing Corporation of America* v. *United States*, 199 Ct. Cl. at 711–12, 468 F.2d at 925. However, plaintiff claims that it can amend its petition to cure these defects, and the court has concluded that it should be permitted to do so.

"IT IS THEREFORE ORDERED:

"(1) The first claim of plaintiff's petition is hereby dismissed.

"(2) Plaintiff shall have 45 days from this date in which to amend the second claim of its petition, in order to show the names and positions of the Government officials who made the alleged assurances to plaintiff, the time and circumstances under which such assurances were made, the authority of such individuals to bind the Government in such a contract with the plaintiff, the specific provisions of the Indian Financing Act of 1974, or any other law which is relevant to the claim, and such other facts from which it might reasonably be concluded that an implied contract in fact was entered into between the plaintiff and the Government."

Upon default of compliance with the foregoing order, on March 29, 1976 the court's rule to show cause issued March 18, 1976 was made absolute, and the petition was dismissed.

No. 218–75. NOVEMBER 21, 1975

Raymond H. Swentek

Public employment; alleged breach of contract; limitation of actions; laches.—On November 21, 1975 the court issued the following order:

Before COWEN, *Chief Judge*, SKELTON and BENNETT, *Judges*.

"In this case plaintiff claims entitlement to damages arising out of breach of two alleged contracts of civilian employment with agencies of the United States Government. On or about October 4, 1968, plaintiff received orders from the Army authorizing his travel to Vietnam and employment in a civilian capacity as an engineer, Grade GS–11. Plaintiff alleges that he had previously been promised employment at Grade GS–12. Based upon assurances from the Army that the grade would be rectified in Saigon, plaintiff avers that he proceeded to Vietnam notwithstanding this discrepancy. After arrival overseas plaintiff states that he was unable to effect correction of his orders.

"Previously plaintiff had filed his application for employment with the Agency for International Development in DaNang, Republic of Vietnam. When notified after arrival in Vietnam of favorable action on his application, he took appropriate steps to secure a transfer to A.I.D. with an ultimate effective date of December 14, 1968. On or about this date, A.I.D. notified plaintiff that a reduction-in-force precluded his planned employment and plaintiff's replacement in his Army job arrived in Vietnam. Faced with these facts, plaintiff returned to the United States on or about December 19, 1968. A petition was filed in this court on June 30, 1975. Defendant now moves for summary judgment, relying on the 6-year statute of limitations, 28 U.S.C. § 2501 (1970), and the doctrine of laches.

"In his opposition and response to defendant's motion, plaintiff forthrightly admits that he is unable to refute the authorities cited by defendant in support of its motion for summary judgment. However, laches is not a defense to a breach of contract claim. *Fraass Surgical Mfg. Co.* v. *United States*, 205 Ct. Cl. 585, 505 F. 2d 707 (1974); *H & M Moving Inc.* v. *United States*, 204 Ct. Cl. 696, 719, 499 F. 2d 660, 672 (1974); *Kaiser Alum. & Chem. Corp.* v. *United States*, 181 Ct. Cl. 902, 388 F. 2d 317 (1967). Plaintiff's claim is, nevertheless, time-barred by the statute of limitations since it was not filed within 6 years of the time when all events occurred which fixed the liability, if any, of defendant and when all that had been required of him had been fulfilled by plaintiff.

Steel Improvement & Forge Co. v. *United States*, 174 Ct. Cl. 24, 355 F. 2d 627 (1966). That date in the circumstances of this case was no later than December 19, 1968. Since plaintiff's claim is thus barred we do not reach the question of whether he would in any event have been able to pursue a claim for breach of contract instead of exhausting administrative remedies provided for Government personnel before coming to court. Public employment, however, does not give rise to a contractual relationship in the conventional sense. *Bers* v. *United States*, 207 Ct. Cl. 941 (orders of May 2, May 30, and October 3, 1975); *Applegate* v. *United States*, 207 Ct. Cl. 999 (order of June 27, 1975); *Urbina* v. *United States*, 192 Ct. Cl. 875, 881, 428 F. 2d 1280, 1284 (1970).

"IT IS THEREFORE ORDERED, upon consideration of the motions, briefs, and without oral argument, that defendant's motion for summary judgment be and it is granted. The petition is dismissed."

No. 395–73. NOVEMBER 24, 1975

Norman G. Shanteau

Pleading and practice; motion for summary judgment; affidavits.—On November 24, 1975 the court issued the following order:

"This is a suit by a Civil Service employee who was demoted and who sues for back pay, plus restoration to his former position. There was a hearing before the employing agency, a hearing before the regional office of the Civil Service Commission, and a review by the Board of Appeals and Review. Defendant filed a motion for summary judgment, together with the lengthy administrative record of the proceedings before the Civil Service Commission, and the motion is based on that record. Plaintiff filed a cross-motion for summary judgment, and in his reply to defendant's opposition to plaintiff's motion for summary judgment, plaintiff attached the affidavits of six individuals. Four of the six affiants testified previously in the hearing held by the employing agency. Two of the affiants did not testify either at the agency hearing or the hearing before the Civil Service Commission. Defendant has moved to strike these affidavits,

first, on the ground that the court's review should be limited to the administrative record; second, if plaintiff is entitled to a de novo trial, defendant contends that he may not submit affidavits to support a cross-motion for summary judgment in lieu of such a trial.

"Plaintiff correctly points out that Rule 101 authorizes the use of affidavits in support of motions for summary judgment, but this rule must be read in connection with the decisions of this court to the effect that when the court finds that a civilian pay case submitted on motions for summary judgment cannot be decided on the basis of the administrative record, the case is remanded for trial, or in some instances to the Civil Service Commision. *Jackson* v. *United States*, 192 Ct. Cl. 765, 428 F.2d 844 (1970); *Booth* v. *United States*, 193 Ct. Cl. 790, 436 F.2d 474 (1971); *Wilson* v. *United States*, 203 Ct. Cl. 676, 492 F.2d 1190 (1974), and *Taylor* v. *United States*, 180 Ct. Cl. 1295 (1967).

"Plaintiff relies on a number of cases in which the court has authorized trials de novo in suits involving back pay, but in all of these cases, there was a court trial. None of the cases authorizes the use of extraneous affidavits to supplement an administrative record in such cases which are submitted on motions for summary judgment.

"Accordingly, IT IS ORDERED that defendant's motion to strike is granted, provided that plaintiff shall have 30 days from this date within which to file a motion requesting the court to deny the motions for summary judgment and to remand the case for trial before a trial judge. The motions shall be supported by a showing that the evidence to be presented in the six affidavits was not available for plaintiff's use at the administrative hearings, that such evidence constitutes newly discovered evidence, or that there are other grounds which entitle plaintiff to a court trial."

On February 6, 1976 the court, by order, denied without prejudice the cross-motions for summary judgment of the parties and remanded the case to the trial division as set forth in the order.

No. 27–70. NOVEMBER 26, 1975

C. M. Rocca, Sr., et al.

Court of Claims jurisdiction; private controversies.—This case was previously the subject of an opinion dated July 19, 1974, 205 Ct. Cl. 275, 500 F.2d 492, and an order dated March 14, 1975, 205 Ct. Cl. 885. On November 26, 1975 the Court issued the following order:

Before COWEN, *Chief Judge*, SKELTON and KUNZIG, *Judges*.

"This case comes before the court on the motion of plaintiffs Verda M. Forester Williams and A. E. Miller, Trustee in Bankruptcy, requesting the court to hold a hearing to determine the respective interests of the plaintiffs in the judgment; to issue an order disbursing certain amounts to Verda M. Forester Williams and A. E. Miller, Trustee, and to order the plaintiffs to endorse the checks issued by the Government in payment of the judgment and to deposit the money in interest-bearing certificates until the respective interests of the plaintiffs have been determined.

"Upon consideration thereof, the court finds:

"(1) The dispute involves substantial issues of fact and questions of state law arising among private parties.

"(2) Rule 131(c)(2), which is applicable only to determination of the amount of the Government's liability, may not be used to litigate the respective entitlement to such amount as among private claimants. *Rose* v. *United States*, 179 Ct. Cl. 224, 229–30, 373 F.2d 963, 966 (1967).

"IT IS THEREFORE ORDERED that the motion of Verda M. Forester Williams and A. E. Miller is hereby denied without prejudice to their seeking the relief sought in a court of competent jurisdiction.

No. 129–72. NOVEMBER 26, 1975

Blount Construction Company

Contracts; disputes; subcontractor claim; delays, disruption, acceleration claims.—Plaintiff, the prime contractor, brings this action on behalf of a subcontractor, claiming entitlement to an equitable adjustment for delays, disruption

and acceleration during contract performance. Alternatively, plaintiff seeks to recover actual costs beyond those allowed by the contracting officer and the contract appeals board incurred during the periods in which the contracting officer and the board have determined the Government is liable (decision of the board reported at 70-2 BCA ¶ 8378). In a recommended decision filed November 11, 1974 Trial Judge Charlotte P. Murphy concluded that the board's findings of fact are supported by substantial evidence, that its conclusions are correct as a matter of law and that plaintiff is not entitled to recover. This case came before the court (Cowen, *Chief Judge*, Davis and Kunzig, *Judges*) on plaintiff's request for review of the recommended decision pursuant to Rule 166(c) on plaintiff's and defendant's motions for summary judgment, having been submitted to the court on the briefs and oral argument of counsel. Since the court agrees with the recommended decision, on November 26, 1975, by order, the court affirmed and adopted the decision as the basis for its judgment in this case, concluded and ordered that plaintiff is not entitled to recover, denied plaintiff's motion, granted defendant's motion and dismissed the petition.

No. 284-73. NOVEMBER 26, 1975

Marilyn C. Dunphy and
Lois A. Ryan

Military pay; active duty; reserve components; release from duty; passovers for promotion; discretion of Secretary; unauthorized acts of Government agents.—On November 26, 1975 the court issued the following order:

Before NICHOLS, *Judge*, Presiding, KASHIWA and KUNZIG, *Judges*.

"We first find that there is no dispute as to material facts. Plaintiffs were both Lieutenant Commanders in the Navy Nurse Corps Reserve, serving on active duty. In the fall of 1972—fiscal year 1973—each plaintiff failed in selection for promotion to the rank of commander for the second time. Both were involuntarily separated from active duty on June 29, 1973.

"To fulfill the reserves statutory mission, to be available for active duty in the Armed Forces of the United States, Congress specially constructed provisions for active duty and release from duty of Reserve members. 10 U.S.C. §§ 671–87 (1970). It was under this authority that plaintiffs entered on active duty:

> (d) At any time, an authority designated by the Secretary concerned may order a member of a reserve component under his jurisdiction to active duty, or retain him on active duty, with the consent of that member. * * * [10 U.S.C. § 672(d) (1970).]

And it is under this same statutory grant of authority that the Secretary of the Navy released plaintiffs from active duty:

> (a) Except as otherwise provided in this title, the Secretary concerned may at any time release a Reserve under his jurisdiction from active duty. [10 U.S.C. § 681 (a) (1970).]

The Secretary of the Navy provided by regulation for the involuntary release from active duty of certain naval reserve officers:

> 5. *Release From Active Duty.*
>
> a. Reserve officers, including warrant officers, in the following categories will be released from active duty as prescribed below:
>
> * * * * *
>
> (5) * * * male officers and women officers of the Medical, Dental, and Medical Service Corps appointed under laws pertaining to male officers, in the grade of commander and below, who twice fail of selection for promotion to the next higher grade while on active duty, will normally be released on 30 June of the fiscal year in which they fail of selection for the second time.

Thus, at least since 1955 and throughout the years plaintiffs have been in the Naval Reserve, by regulation the Secretary has exercised his statutory authority to release failed-of-selection reserve officers below the grade of captain upon the second failure. That exercise is presently found in the Manual of the Bureau of Naval Personnel, article 3830110, promulgated by the Chief of Naval Personnel as approved by the Secretary of the Navy. We hold that releases of plaintiffs

under the above-mentioned statute and regulation were entirely within the discretion of the Secretary of the Navy. We are asked to review such discretionary acts. We refuse such a review and in doing so we quote from a very recent failure-of-selection case, *Schlesinger* v. *Ballard*, 419 U. S. 498, 510 (1975):

> * * * This Court has recognized that 'it is the primary business of armies and navies to fight or be ready to fight wars should the occasion arise.' *Toth* v. *Quarles*, 350 U.S. 11, 17. See also *Orloff* v. *Willoughby*, 345 U.S. 83, 94. The responsibility for determining how best our Armed Forces shall attend to that business rests with Congress, see United States Constitution, Art. I, § 8, cls. 12–14, and with the President. * * *

We also quote from *Goldstein* v. *United States*, 131 Ct. Cl. 228, 232, 130 F. Supp. 330, 332, *cert. denied*, 350 U.S. 888 (1955), where this court stated:

> * * * Nor can this court undertake to grant plaintiff promotions or assignments which the Army having jurisdiction over him decided not to make. * * *

See *Norman* v. *United States*, 183 Ct. Cl. 41, 392 F. 2d 255 (1968), *cert. denied*, 393 U.S. 1018 (1969); *Donnelly* v. *United States*, 133 Ct. Cl. 120, 134 F. Supp. 635 (1955); *Chase* v. *United States*, 159 Ct. Cl. 610 (1962); *Johnson* v. *United States*, 150 Ct. Cl. 747, 280 F. 2d 856 (1960), *cert. denied*, 365 U.S. 882 (1961).

"Plaintiffs next argue that the contents of a mid–1971, mimeographed, circular-type Navy letter and a 1972 article in a Navy publication, "All Hands," bind the Secretary of the Navy not to release plaintiffs from active duty prior to the completion of 20 years' active service. The letter was a mere "summary" and a "general guideline." The letter itself suggested that any specific question should be directed to the Nursing Division. The article in the Navy magazine carried a short paragraph entitled "Separation of Officers Not Selected." The entire article itself is also described on the lead page of the magazine as a mere summary. The article gave summarily the rules regarding regular naval officers but the rules governing naval reserve were covered by one short sentence as being "similar to the provisions of law for regular Navy officers." An examination of these inadequate

exhibits shows that the letter and article were clearly not intended for fastening consequences, as plaintiffs argue. The United States Court of Appeals for the District of Columbia Circuit in *Donovan* v. *United States*, 433 F. 2d 522, 523 (1970), *cert. denied*, 401 U.S. 944 (1971), refused fastening of mandatory consequences "on all sorts of papers emanating from Federal agencies, without regard to actual intentions." We likewise hold and refuse to take these letters to have the consequences plaintiffs argue. The United States is neither estopped nor bound by the unauthorized acts of its agents. *Federal Crop Insurance Corp.* v. *Merrill*, 332 U.S. 380 (1947); *Western Pennsylvania Horological Institute, Inc.* v. *United States*, 146 Ct. Cl. 540, 546 (1959); *United States* v. *Ulvedal*, 372 F. 2d 31 (8th Cir. 1967); *United States* v. *Rossi*, 342 F. 2d 505 (9th Cir. 1965); *Michals* v. *Federal Savings & Loan Insurance Corp.*, 413 F. 2d 144 (7th Cir. 1969); *Gray* v. *Johnson*, 395 F. 2d 533 (10th Cir.), *cert. denied*, 392 U.S. 906 (1968); *ANA Small Business Investments, Inc.* v. *Small Business Administration*, 391 F. 2d 739 (9th Cir. 1968); *Allison* v. *United States*, 426 F. 2d 1324 (6th Cir. 1970); *Montilla* v. *United States*, 198 Ct. Cl. 48, 457 F. 2d 978 (1972); *Brown* v. *Richardson*, 395 F. Supp. 185 (W. D. Pa. 1975).

"Relative to the commission dated February 29, 1972, appointing plaintiff Dunphy a permanent Lieutenant Commander, Nurse Corps, United States Navy, this court finds that said certificate was issued as a result of obvious error. We find that plaintiff Dunphy was never granted a regular Navy commission.

"Defendant's motion for summary judgment is allowed and plaintiffs' petition is hereby dismissed."

No. 370–73. NOVEMBER 26, 1975

LeRoy F. Mooney

Civilian pay; appointment and tenure; reclassification; summary judgment; affidavits.—On November 26, 1975 the court issued the following order:

Before KASHIWA, *Judge*, Presiding, LARAMORE, *Senior Judge*, and BENNETT, *Judge*.

"This case is before the court on cross motions for summary judgment. Both parties have submitted affidavits and exhibits in support of their respective motions for summary judgment. On a motion for summary judgment this court will adopt as findings of fact statements in uncontroverted affidavits accompanying the motion. *Weyerhauser Co.* v. *United States*, 184 Ct. Cl. 492, 395 F. 2d 1005 (1968); *Royal Indemnity Co.* v. *United States*, 178 Ct. Cl. 46, 371 F. 2d 462, *cert. denied*, 389 U.S. 833 (1967). Defendant's supporting affidavit by Leo T. Rickwa, head of the Position Classification Section, Department of the Navy, Office of Civilian Manpower Management (hereafter OCMM), is uncontroverted. Plaintiff does not take issue with any of the material facts stated in the Rickwa affidavit. Plaintiff's general affidavit on file is of no aid to plaintiff. Mere formal denials or general allegations which do not show facts in detail and without precision are insufficient to prevent award of summary judgment. *Royal Indemnity Co.* v. *United States*, *supra; Hartwig* v. *United States*, 202 Ct. Cl. 801, 485 F. 2d 615 (1973); *Burton* v. *United States*, 186 Ct. Cl. 172, 404 F. 2d 365 (1968), *cert. denied*, 394 U.S. 1002 (1969).

"Plaintiff, a classified civil service employee of the Department of the Navy working in the Naval District of Washington, held the position of Superintendent, Maintenance Division, Public Works Department, as of July, 1970, and was graded as a WS–16 on the wage board schedule. On October 1, 1970, the public works functions at the Washington Navy Yard and the Arlington Service Center were consolidated and resulted in the plaintiff assuming responsibility for the related public works function and an additional 112 employees.

"On April 2, 1971, a new job description for plaintiff's position was submitted to the Office of Civilian Manpower Management, Department of the Navy, for approval. The proposed position was submitted for reclassification and approval as a WS–18 in the wage board schedule.

"In July, 1971, an additional reorganization of the Public Works Department took place, resulting in the consolidation of the Maintenance and Utilities Divisions and plain-

tiff assuming the responsibility for approximately 100 additional employees.

"At this time, new Civil Service Commission standards for classifying all superintendent positions were being prepared. In addition, consideration was being given to converting positions to the general schedule (GS) instead of the wage schedule (WS). On May 3, 1972, the position in question was classified in the general schedule system as a GS–13.

"The new position was then advertised on May 15, 1972, as a vacancy, and plaintiff was subsequently selected and promoted to the position on June 5, 1972.

"On March 24, 1972, plaintiff filed a grievance within the Department of the Navy wherein he sought reclassification of the proposed position to WS–18 made retroactive to October 1, 1970. Plaintiff alleged that the reclassification of the proposed position was being excessively delayed causing him a loss of the increased salary. After examination of the facts, the grievance was denied by the Secretary of the Navy on September 11, 1972. Plaintiff thereafter sought relief from the Civil Service Commission and the General Accounting Office. He was denied relief.

"Plaintiff filed his petition in this court for a judgment that he is entitled to an equivalent grade of WS–18, made retroactive to October 1, 1970, because the delay in classifying him "severely prejudiced" his position in the civil service. Plaintiff prays for a judgment in the amount of $10,000. Plaintiff makes the following contentions:

> (1) That from October 1, 1970, to June 5, 1972, plaintiff was performing the work of a WS–18 employee pursuant to a reorganization, and order to so perform validly issued by the Public Works Officer at the activity, and that from at least July 1, 1971, plaintiff legally held this position, but the classification was not effected.
>
> (2) That the amount of time taken by the defendant—20 months (October 1, 1970–May 3, 1972)—to classify the plaintiff's position is inherently and on its face unreasonable, arbitrary, and capricious.

"It is an established rule that Federal Government employees are entitled only to the salaries of the position to which they are appointed regardless of the duties they actu-

ally perform. *Dianish* v. *United States*, 183 Ct. Cl. 702, 706 (1968). In the instant case the uncontroverted affidavit shows that the new position was not officially created until May 3, 1972, and plaintiff's legal right to said position did not exist prior to plaintiff's appointment on June 5, 1972.

"It is clear from the affidavit of Leo T. Rickwa that plaintiff's allegation of excessive delay is unfounded. The period of time from October, 1970, to May, 1972, was utilized by OCMM and the Civil Service Commission in activities designed to fairly and accurately reclassify over 500 Navy superintendent positions in accordance with Civil Service Commission standards and Navy personnel policy. To accomplish the work of reclassification, it was necessary for OCMM to investigate, audit, study, consult, and recommend to the Civil Service Commission and then review, evaluate, and classify each of the more than 500 positions. Unfortunately, these activities took from October, 1970, to May, 1972, instead of a shorter period desired by plaintiff. Nevertheless, we find that the steps taken by OCMM and the Civil Service Commission were necessary procedures under law; and the fact that they took the aforementioned period of time does not properly give rise to a charge that defendant acted unreasonably, arbitrarily, or capriciously, or that there was an excessive delay in reclassifying plaintiff's position.

"Defendant has provided an uncontroverted explanation for OCMM's failure to implement the initial recommendation to reclassify the superintendent position to WS–18 and also the reason it took from October, 1970, until May, 1972, for the superintendent position to be converted to the GS schedule. These reasons establish that plaintiff was never appointed to a WS–18 superintendent position and, further, that under the circumstances there was no excessive delay by OCMM in reclassification of the position. We find that the actions of OCMM and the Civil Service Commission were appropriate in all regards and did not constitute an abuse of administrative discretion.

"Plaintiff's cross motion for summary judgment is denied. Defendant's motion for summary judgment is allowed. Plaintiff's petition is dismissed."

No. 335–74. NOVEMBER 26, 1975

William Dargan

Civilian pay; adverse action; notice; oral reply; Internal Revenue employee.—On November 26, 1975 the court issued the following order:

Before COWEN, *Chief Judge*, DAVIS and KUNZIG, *Judges*.

"This case comes before the court on the parties' cross-motions for summary judgment. Upon consideration of the motions and the briefs of the parties and after hearing oral argument, the court finds that by letter of May 7, 1973, plaintiff, an employee of the Internal Revenue Service, was notified that the agency proposed to remove or otherwise discipline him for eight specified reasons and twelve supporting specifications, including knowingly submitting a false affidavit to the IRS Inspection Division, failure to timely file Federal and District of Columbia income tax returns, failure to report all of plaintiff's gross income on his Federal and D.C. income tax returns, and failure to obtain permission, as required by the rules of the agency, to engage in outside employment. On May 30, 1973, plaintiff submitted a five-page written reply prepared by his counsel, and on June 4, 1973, he made an oral reply, at which time he was again assisted by competent counsel. On July 18, 1973, plaintiff was notified that the reasons and specifications contained in the notice had been sustained and that he would be removed from his position, effective July 20, 1973. Plaintiff appealed to the Civil Service Commission, and after a hearing held on October 16, 1973, where he was represented by counsel, the Appeals Examining Officer of the Commission sustained the agency action, and on December 26, 1973, this decision was affirmed by the Board of Appeals and Review.

"Plaintiff's principal contention is that he was denied the right to make a meaningful, oral reply in violation of the statute, 5 U.S.C. § 7512(b)(2) and the regulation, 5 C.F.R. § 752.202(b). This contention rests primarily on the failure or refusal of the oral reply officer to state or explain the nexus between plaintiff's conduct and the efficiency of the

Service. On this issue, the court finds that the oral reply officer was the Assistant Director of the Office of International Operations of the IRS; that he was the same official who sent plaintiff the notice of proposed adverse action; that he told plaintiff that he was the individual who would recommend the action to be taken on the charges against plaintiff, and that he gave plaintiff and his counsel a full opportunity to advance any reason which they relied on as a defense to the proposed adverse action. The defendant was not required either in the proposed notice of adverse action or during the hearing of plaintiff's oral reply to state how his removal would promote the efficiency of the Service, *Meyers* v. *United States*, 169 Ct. Cl. 1, 6 (1965). The oral reply officer was in a line of authority superior to plaintiff and, as he advised plaintiff, he was in a position to make a meaningful recommendation to the officer who would ultimately make the decision. Under all the circumstances, the court concludes that plaintiff's removal was not procedurally defective for the failure to accord him a meaningful oral reply pursuant to the applicable statute and regulations, *Grover* v. *United States*, 200 Ct. Cl. 337 (1973).

"At the hearing before the Civil Service Commission plaintiff did not deny the truth of any of the charges specified in the notice but did offer evidence which he contended would justify or excuse his conduct. The court finds that the determination of the Civil Service Commission that the evidence before it sustained the eight reasons and the supporting specifications for plaintiff's discharge is fully supported by substantial evidence. The court also finds that the Civil Service Commission correctly concluded that plaintiff's conduct was a violation of the Rules of Conduct for Internal Revenue Service Employees and the provisions of the Internal Revenue Code.

"Based upon the foregoing, the court concludes that the administrative decisions are neither arbitrary nor capricious and that there was a sufficient basis for the defendant's conclusion that plaintiff's removal was for such cause as would promote the efficiency of the Service. This conclusion is based on the totality of the evidence in the administrative record rather than upon the evidence relating to any one of

the charges against plaintiff. *See Williams* v. *United States*, 193 Ct. Cl. 440, 434 F.2d 1346 (1970); *Birnholz* v. *United States*, 199 Ct. Cl. 532 (1972); *Burkett* v. *United States*, 185 Ct. Cl. 631, 402 F.2d 1002 (1968).

"IT IS THEREFORE ORDERED that plaintiff's motion for summary judgment is denied, defendant's cross-motion for summary judgment is granted, and plaintiff's petition is dismissed."

No. 97–74. NOVEMBER 26, 1975

Sacramento Northern Railway

Carriers; limitation of actions; counterclaim to recover overcharges.—On November 26, 1975 the court issued the following order:

Before KASHIWA, *Judge*, Presiding, LARAMORE, *Senior Judge*, and BENNETT, *Judge*.

"This case involves charges for freight transportation services rendered by plaintiff for defendant. It is before us on a stipulation of facts. It is stipulated that plaintiff is due a total of $1,371.03 on items 1, 3, and 5. By its counterclaim defendant seeks to recover $292.98 as overcharges on items 2 and 4. Plaintiff is not seeking any additional freight charges on these two shipments. It is also stipulated that if defendant's counterclaim is time-barred, as plaintiff contends, plaintiff is entitled to recover $1,371.03 and if defendant's counterclaim is not time-barred, plaintiff is entitled to recover $1,078.05 ($1,371.03 less $292.98).

"The sole question which remains in this cause relates to the timeliness of the counterclaim of defendant. Defendant claims that it was overcharged with relation to items 2 and 4 of plaintiff's claims. The bills involved in items 2 and 4 were submitted by plaintiff and paid by defendant in March, 1971, prior to audit. Subsequently, on February 15, 1974, plaintiff filed this suit to recover among other items additional freight charges with respect to items 2 and 4. On August 15, 1974, defendant denied liability for the additional freight charges and filed a counterclaim.

"It is provided in 49 U.S.C. §§ 16(3) (a) and (d) (1970), as follows:

> (a) All actions at law by carriers subject to this chapter for recovery of their charges, or any part thereof, shall be begun *within three years* from the time the cause of action accrues, and not after.
>
> * * * * *
>
> (d) If on or before expiration of the two-year period of limitation in subdivision (b) of this paragraph or of the three-year period of limitation in subdivision (c) of this paragraph a carrier subject to this chapter begins action under subdivision (a) of this paragraph for recovery of charges in respect of the same transportation service, or, without beginning action, collects charges in respect of that service, *said period of limitation shall be extended to include ninety days from the time such action is begun* or such charges are collected by the carrier. [Emphasis suppied.]

Defendant in this case should have filed its counterclaim within 90 days of February 15, 1974. This it failed to do. Instead, it filed it on August 15, 1974, which was clearly more than 90 days after the beginning of plaintiff's action.

"Defendant's motion for judgment on its counterclaim is denied. Defendant's counterclaim is hereby dismissed.

"Plaintiff's motion for judgment in the amount of $1,371.03 is allowed."

No. 258–74. NOVEMBER 26, 1975

Allen Mazany

Sale of imported merchandise; "as is, where is"; unauthorized acts of Government agents.—On November 26, 1975 the court issued the following order:

Before NICHOLS, *Judge*, Presiding, DURFEE, *Senior Judge*, and KASHIWA, *Judge*.

"Defendant offered for sale a list of imported merchandise entered through customs but held in warehouse and never delivered to consignees because the duties and charges were never paid. Plaintiff bid $275 on a Lot advertised as 32 cases

of stainless steel round bars. As this bid was the highest, defendant accepted payment and gave plaintiff a receipt on the appropriate Customs form. However, plaintiff was unable to obtain delivery at the warehouse because the merchandise was not there. It had been delivered at another port to the consignee, who had paid all duties and charges, long before the offer for sale. The record does not explain how the mistake was made. Plaintiff requests an order directing defendant to produce the documents and asks permission to amend setting forth its damages on receipt of the said documents. Both parties have moved for summary judgment.

"Defendant was not a manufacturer or dealer. The entire circumstances suggest that defendant offered abandoned merchandise on an 'as is, where is' basis, with no commitment for specific performance, or a money equivalent, with respect to merchandise not found and not existing in the warehouse specified in the catalog of sale. Plaintiff was invited to inspect before he bid. The same legal interpretation is supported by provisions that the merchandise could be withdrawn from sale at any time if the consignee paid duties and charges, and that 'no allowance will be made for any deficiency found after sale.' Defendant refunded the bid price which is the most it contracted to do in the circumstances. If an intent to offer bars, though in a consignee's possession, can be imputed to defendant's officers, such intent could not have been legally effectuated in view of the enabling legislation, 19 U. S. C. § 1491 (1970), which does not authorize sale of merchandise such as that involved here, which was neither unclaimed nor abandoned. Accordingly, the contract would be illegal and, therefore, unenforceable, if it meant what it would have to mean if plaintiff were to recover on it in this case. The United States are not contractually bound by acts of officers outside the scope of their authority. *Porter* v. *United States*, 204 Ct. Cl. 355, 496 F. 2d 583 (1974), *cert. denied*, 420 U. S. 1004 (1975).

"Accordingly, IT IS ORDERED that the plaintiff's motion for summary judgment is denied, the defendant's motion for summary judgment is allowed and the petition is dismissed."

No. 271–74. NOVEMBER 26, 1975

Guy A. Devine

Military pay; disability retirement pay; laches; prejudice; shifting of burden of proof.—On November 26, 1975 the court issued the following order:

Before KASHIWA, *Judge*, Presiding, LARAMORE, *Senior Judge*, and BENNETT, *Judge*.

"This case comes before the court on cross-motions of the parties for summary judgment. Plaintiff's petition filed July 30, 1974, seeks disability retirement pay based on his military service with the Army. Plaintiff was released from active duty on February 27, 1948, with the rank of Major, Finance Department, following a physical examination which pronounced him physically qualified for general military service. Plaintiff did not contest the Army's finding or seek a Medical Review Board or a Retiring Board determination that he should be retired for disability. In February 1948 plaintiff requested appointment in the Officer Reserve Corps stating his fitness for duty. His application was later approved with the rank of Lieutenant Colonel. In March 1948 plaintiff sought disability compensation, unsuccessfully, from the Veterans' Administration. However, plaintiff persevered in his attempt to get a disability rating and compensation from the Veterans' Administration and after receiving various ratings for hypochondriasis was successful on February 2, 1966, in winning a VA rating of 40 percent consisting of 20 percent for arthritis of the cervical spine, 10 percent lumbosacral strain, and 10 percent conversion reaction. In the meantime, in 1963, plaintiff graduated from law school. In September 1972 plaintiff for the first time filed an application with the Army Board for Correction of Military Records, relying upon the results of the VA determination to support his request that his records be changed to reflect a separation from the service for disability instead of as a surplus officer. On January 30, 1974, plaintiff's application was denied on the grounds that there was insufficient evidence to indicate probable material error or injustice on the reasons for his separation. This suit followed on

July 30, 1974, alleging that the Correction Board action was arbitrary, capricious, erroneous in law and unsupported by substantial evidence, and demanding that it be set aside and that plaintiff be awarded disability retirement pay from his release on February 27, 1948, less any compensation received from the Veterans' Administration, and for correction of plaintiff's records to reflect his disability from 1948.

"Defendant interposes three defenses to the claim: the 6-year statute of limitations, 28 U.S.C. § 2501; the doctrine of laches; and that on the merits the decision of the Correction Board was correct and should be sustained.

"The equitable doctrine of laches has frequently been applied by this court to bar stale claims. While it has not often been applied in military pay cases, it was done at least as long ago as in *Plunkett* v. *United States*, 58 Ct. Cl. 359 (1923), and more recently in *Brundage* v. *United States*, 205 Ct. Cl. 502, 504 F.2d 1382 (1974), *rehearing denied*, 206 Ct. Cl. 823 (1975), *cert. denied*, 421 U.S. 998; *Steuer* v. *United States*, 207 Ct. Cl. 282 (1975); and in *Sharp* v. *United States*, 207 Ct. Cl. 975 (1975), among others. It is unnecessary to repeat the careful explanation of the doctrine set forth in those cases. Suffice it to say that we see no good reasons why it cannot be applied to a claim for disability retirement where the elements of laches are present, such as unjustified and unreasonable delay in bringing suit, to the prejudice of defendant.

"Plaintiff's case illustrates some remarkable delay. Plaintiff admits this but seeks to justify it on the grounds of ignorance of his legal rights and of the nature of his disabilities. He also says he was misled as to these rights by the VA and veterans' organizations which represented him. However, plaintiff did, without delay, upon his separation from military service, pursue his rights before the Veterans' Administration while at the same time proclaiming his fitness for reserve duty. Of course, plaintiff's protracted effort for administrative relief from the VA was not a prerequisite to the filing of a proper claim before a Retiring Board, the Correction Board, or in court. This effort does not excuse his delay. *Gersten* v. *United States*, 176 Ct. Cl. 633, 636, 364 F.2d 850, 852 (1966). Plaintiff never did ask the Army to retire him for disability. It was over 24½ years from the time of his

separation from the Army before he sought relief from the Correction Board, which was available to him at all times. After plaintiff learned from the VA in 1966 all he had to know to pursue a claim before the Correction Board he still waited over 6½ years to appeal it. It took him 26½ years from his separation to come to court. We find this lawyer's claim of ignorance of his rights and of such things as limitation periods and laches to be incredulous.

"Defendant says that although plaintiff pursued a permissive administrative remedy with vigor before the VA, his failure to resort to a board that could grant him disability retirement—a statutory board—was neglected without good cause, to defendant's prejudice. Defendant invokes the equitable defense of laches. The liability of laches as a defense must be determined on a case-by-case basis. Prejudice to sustain a claim of laches likewise may have a variety of degrees and forms, depending on the facts and type of case.

"Defendant tells the court that it is now impossible objectively to determine plaintiff's physical condition at the time of his separation from the service in 1948, with any reliable certainty, or to determine whether or not any maladies he may now have are connected to his pre-1948 service. It is suggested that plaintiff's advancing age, and injuries he may have experienced in the intervening 27 years, may contribute to his present condition. Further, much of the medical evidence of record here pertains to the VA evaluation of plaintiff's capacity for civilian employment and not as to whether he was fit for retention in the Army. It is apparent that those best able to speak of service-connected disabilities are those who examined plaintiff at the time of his separation in February 1948. It is not sufficient here that there is a documentary file. Defendant and plaintiff are both entitled to cross-examine the doctors who made the medical report in 1948, and it is just too late now. Even if available, those doctors could hardly be expected to recall observations made over a quarter of a century ago. Plaintiff's allegations call into question the competence and veracity of those officials. They should have the right to defend and explain their decision when their recollection is fresh—for their own reputations and the public honor. *Brundage* v. *United States*, *supra*. We think this to be one of those flagrant cases dis-

cussed in *Brundage* v. *United States*, *supra*, *Steuer* v. *United States*, *supra*, and *Gersten* v. *United States*, *supra*, where the longer the delay the less need there is to search for specific prejudice and the greater the shift to plaintiff of the task of demonstrating lack of prejudice. The shift has taken place here and plaintiff has not met his burden. Defendant has shown us enough basis for prejudice by which it is harmed or by reasonable presumption thereof because of plaintiff's failure to show otherwise. If the doctrine of laches has any meaning at all, it must be applied to the facts of this case. For this reason we do not reach defendant's other defenses although they may not be without merit.

"IT IS THEREFORE ORDERED that for the foregoing reasons and upon the foregoing authorities and those therein adopted by reference, upon consideration of the pleadings, cross-motions for summary judgment, supporting briefs, and after oral argument, plaintiff's motion for summary judgment is denied. Defendant's motion for summary judgment is granted. The petition is dismissed."

On January 30, 1976, plaintiff's suggestion for rehearing *en banc* and for rehearing and other relief under Rule 151(b) were denied.

APP. No. 2–75 NOVEMBER 26, 1975

Bay Mills Indian Community, et al.

Indian claims; appeal from Indian Claims Commission.—This case arises from a claim brought by the Chippewa Indians of Sault Ste. Marie, and is an appeal from the decision of the Indian Claims Commission concluding that the April 15, 1856 fair market value of the rights ceded by the Treaty of August 2, 1855 was $15,400 and that the appraisal by Commissioner Manypenny of $17,475 and the payment of that amount to the Chippewa Indians of Sault Ste. Marie compensated them for the 1855 cession of their encampment ground and fishing rights. On November 26, 1975 the court issued the following order:

Before SKELTON, *Judge*, Presiding, DURFEE, *Senior Judge*, and BENNETT, *Judge*.

"This case comes before the court on appeal from the Indian Claims Commission order in Docket No. 18–F en-

tered October 24, 1974, dismissing the petition filed by appellants before the Commission, having been submitted to this court on the briefs and oral argument of counsel. Upon consideration thereof, it is concluded that the decision of the Indian Claims Commission was based on substantial evidence, and

"IT IS ORDERED that the order and decision of the Indian Claims Commission be and the same is affirmed and the appeal in this court is dismissed."

No. 394–72. JANUARY 9, 1976

Sam Corbino and Jesse Pursell

Contracts; interpretation; abandoned property; artifacts; bottles.—On January 9, 1976 the court issued the following order:

Before NICHOLS, *Judge*, Presiding, DURFEE, *Senior Judge*, and KASHIWA, *Judge*.

"The instant case has been before the court previously. In *Corbino* v. *United States*, 203 Ct. Cl. 278, 488 F. 2d 1008 (1973), another panel denied a motion to dismiss on the ground that the contract was not to be financed with appropriated funds. The panel initially supposed any judgment could be financed by sale of part of the property in dispute, but denied a motion for rehearing which asserted that such property could not be legally sold.

"The trial judge has now submitted a memorandum opinion under Rule 13(a). He reports a correspondence with both parties extending over a year's time, in which he endeavored, with apparently unsatisfactory cooperation by either side, to ascertain what the triable issues were. He finally concluded there were none, on the basis of papers before him, and the recommended opinion holds for plaintiff on entitlement, subject to remand for quantum and to defendant's opportunity to challenge the recommended result under the rules.

"Defendant's Request for Review before us displayed marked indignation, going so far as to propose on oral argument a remand to another trial judge. It says there are triable

issues of fact, and it had no opportunity to brief the law to the trial judge.

"We think, in the view the trial judge took of the case, the procedure he adopted was proper. A trial judge who endeavors to keep the cases on his docket moving along, and to adjudicate cases at the earliest moment when they are ripe for adjudication, deserves commendation not censure. Of course, if we hold there are triable issues, they will have to be remanded for trial. Defendant is not prejudiced because it has its opportunity to make its pitch to us, an opportunity of which it has taken full advantage with able briefing and argument. We agree generally with the trial judge's opinion, which has been furnished to the parties, but prefer not to adopt everything in it as our own. We hold there are no triable issues and judgment must be entered for plaintiff.

"The disputed contract is for salvage of cargo aboard the steamboat *Bertrand*, which sank on April 1, 1865, in the Missouri River while bound from St. Louis, Mo., towards Fort Benton, Montana Territory. With a shift of the river channel, the wreck became buried under dry land, and was located in the DeSoto National Wildlife Refuge. The plaintiffs expected to recover gold, quicksilver and what they called 'whiskey'. The gross value of all recoveries, after measures not here relevant, were to be divided 60–40 between plaintiffs and defendant, exclusive of 'artifacts,' reserved wholly to defendant, and defined as "to include all man made objects or parts thereof."

"The defendant has appropriated entirely to itself practically all the merchandise actually salvaged, excepting only the small amount of quicksilver found. It has offered to deliver, but plaintiffs have refused, 60% of the contents of 76 bottles of whiskey, but not the containers in which the whiskey was found. Defendant claims full title to containers and contents of 4,025 other bottles, mostly bitters, of several brands, but some brandy, schnapps and champagnes. Thus the dispute relates primarily to 4,091 ancient bottles which defendant concedes have a substantial value for the antique trade, though offering so many bottles at once would probably break the market. We are not informed what, if anything, the contents are worth.

"The trial judge was aware, as defendant here reiterates, that defendant proposed to offer testimony that, semantically, the bottle are 'artifacts'. Indeed, so far as mere semantics go testimony would be hardly necessary. The bottles plainly meet the contract definition, quote *supra*. The interpretative difficulty is that the *Bertrand* and her entire equipment, outfit, stores, and cargo, meet it as well. Note also Websters definition (*3rd unabridged*):

> a usually simple object (as a tool or ornament) showing human workmanship or modification

Also per Webster, an object is:

> something that is put or may be regarded as put in the way of some of the senses: something that is visible or tangible (observed an—in the distance)

There is no definition limiting 'object' and therefore 'artifact' to solid things. Therefore liquids are not excluded. It would appear that everything the parties expected to find: gold, if in the usual ingot form, quicksilver, whiskey (and its containers in whatever form, barrels, demijohns or bottles) were all 'artifacts', and therefore the artifact exclusion would swallow up the entire treasure trove and leave plaintiffs with nothing to show for their expenditure and pains.

"The trial judge concluded, quite reasonably, we believe, that the scope of the term 'artifact' had to be limited to less than its dictionary meaning to give the contract its intended meaning and effect. Defendant's expert witnesses had, it would appear, no knowledge of the actual intent of the parties, and if put on the stand, would have simply argued semantics, relying chiefly on dictionaries the court could consult itself.

"Better light on what defendant meant by the term 'artifact' is thrown by the provision in Article 12, that:

> In the event any such items [artifacts or valuable historical items] are discovered during the performance under this contract, operations shall be suspended temporarily until the find can be evaluated by the Chief, Archeological Research, Midwest Region, National Park Service * * *

Surely defendant did not expect operations to come to a halt each time one of 4,091 bottles was found.

"The contract uses the term 'whiskey' with equal inaccuracy. It requires in Article 11:

> * * * the disposition of any whiskey will be governed by and in accordance with United States laws, rules, and regulations.

Defendant could hardly have intended that schnappes, champagne and brandy were to be disposed of without regard to United States laws etc.

"Bitters were widely used for beverage purposes by our ancestors. They were themselves highly alcoholic, and were often ingredients of alcoholic mixed drinks. The relatively large quantity of bitters in the *Bertrand's* cargo would indicate a beverage destination, not medicinal, unless there was a terrible outbreak of hypochondria in the mining country to which they were consigned.

"Defendant would offer proof of what everyone knows, that technically bitters are not whiskey. We think they are, under this loosely drawn contract, even so. If one inveighs against 'the demon Rum' he is not condoning whiskey drinking, and if one sings 'whiskey is the life of man * * *' he is not excluding schnappes, brandy and bitters. A technical distinction between whiskey and other alcoholic beverages is here capricious from every point of view. The trial judge was quite right in concluding he would not be aided by defendant's semantics, nor would we.

"It is normal in commerce for the denomination of merchandise to include its usual container. It is not likely the bills of lading for the *Bertrand's* cargo, or her manifest, would have enumerated separately the quicksilver and the flasks it was in, the bitters and the bottles. We think that, presumptively, the right to share 60–40 in the treasure trove contents carries with it the right to the containers. Defendant offers nothing to refute or rebut this.

"In construing the contract as he did, the trial judge relied on the rule of *contra proferentem*. Defendant would show the contract was negotiated—not any helpful occur-

rence during negotiation, just the mere fact of negotiation, to refute *contra proferentem*, which defendant believes applies only to contracts of adhesion. It admits that after negotiation it drafted the contract, presumably to reflect the previous oral agreements. We think that we can pass by this issue because the involved interpretations, besides *contra proferentem*, also are required by the rule of construing a contract so as to avoid a forfeiture, 3 CORBIN ON CONTRACTS § 552 (1960 Ed.); *Carlin* v. *City of Newark*, 114 A. 2d 761 at 769 (Superior Ct., N.J. 1955). Bilateral contracts should be applied, if fairly possible, so as not to put one side at the mere will or mercy of the other. *Contra Costa County Flood Control Dist. v. United States*, 206 Ct. Cl. 413, 512 F. 2d 1094 (1975). Defendant does not claim to have owned the *Bertrand* or any of its cargo. It contributed nothing but permission to enter on vacant land. Plaintiffs contributed substantial effort and expense. Of the fruits of the operation, defendant by its construction of the contract takes virtually all. Plaintiffs take nothing but a derisory remnant.

"For these reasons, the artifact exclusion does not exempt from the contract 60–40 split the alcoholic beverages found in the *Bertrand* and their containers.

"The trial judge has contributed an interesting and scholarly history of 40 U.S.C. § 310, purporting, not without persuasiveness, to show that Act is wholly inapplicable to the *Bertrand* wreck and its cargo. We cannot adopt this as our own as it apparently conflicts with the law of the case as established in the prior decision. Reference of the issue to an *en banc* court would apparently be required. We may assume for purposes of the present case that, by the references in the contract, plaintiffs have estopped themselves to deny that 40 U.S.C. § 310 is applicable. They have not denied it in fact. The trial judge's analysis was made *sua sponte* and cannot be applied to the issues in this case as framed by the parties.

"Likewise, the contract references to the Antiquities Act, 16 U.S.C. §§ 431–433 would seem to make it applicable by estoppel. The trial judge appears correct in pointing out that defendant violated the Act in authorizing excavation

by plaintiffs without establishing that they were 'institutions * * * properly qualified to conduct such * * * excavation * * *' in the language of § 432. This does not make the Act inapplicable in other respects. We think, however, that the further provision of § 432 '* * * that the gatherings shall be made for permanent preservation in public museums' does not mean that every antique man-made article excavated must willy-nilly be swept into a museum. Curators might well be reluctant to provide space to exhibit or even store every single article excavated. Some exercise of discretion must be implied and there seems no valid reason why it should not be exercised in advance by contract with the diggers. Thus defendant cannot invoke the statute to change the allocation of fruits called for by the contract unless it is prepared to show the contract allocation is illegal under the statute, and that it has not done. We return, therefore, to the meaning of the contract allocation of so-called 'artifacts' wholly to defendant, as the one key issue in the case. Defendant's assertion that the bottles being 'artifacts' cannot legally be sold to satisfy the judgment, pre-judges that central issue.

"If defendant would prefer not to sell bottles to satisfy the judgment, or deliver them in kind, but instead to pay the judgment from appropriated funds and keep all the bottles, let it apply for an *en banc* court to modify the prior opinion in line with the trial judge's views. The *en banc* court would of course be free to hold that such a change of position came too late. *Kaiser Aluminum & Chemical Corp.* v. *United States*, 187 Ct. Cl. 443, 409 F. 2d 238 (1969) (concurring op. by Chief Judge Cowen). The full court might consider that a seeming mistake concerning 40 U.S.C. § 310 should not stand in perpetuity.

"Accordingly, after briefing and oral argument, judgment is entered for the plaintiffs and the cause is remanded to the Trial Division for proceedings to determine quantum under Rule 131 (c)."

In accordance with the foregoing order and a stipulation of the parties, it was ordered on April 16, 1976 that judgment be entered for plaintiffs for $38,984.40.

No. 470–72. JANUARY 9, 1976

First National City Bank and
Samuel B. Seidel, as executors
of the last will of Clarence J.
Goldsmith, deceased

Taxes; estate tax; taxable estate; ascertainable value of charitable remainder.—On January 9, 1976 the court issued the following order:

Before KASHIWA, *Judge*, Presiding, LARAMORE, *Senior Judge*, and BENNETT, *Judge*.

"Clarence J. Goldsmith died testate on September 21, 1967. His will provided in paragraph second that certain real property which he owned in New York was to be placed into trust with the net rents to be paid to his wife for life. After her death the trustees are to pay or accumulate the net rents in the manner provided in paragraph third, one-half paid to his sister for life and one-half to his daughter as deemed advisable with the balance of the said daughter's one-half to be accumulated. Upon their deaths the property is to go to charity.

"Plaintiffs, who are executors of the estate, timely filed an estate tax return on December 17, 1968, and paid the tax shown thereon. On the return the taxpayers claimed a charitable deduction of $73,617.67 which they asserted was the value of the remainder interest in the property named in paragraph second of the will. Upon audit the Internal Revenue Service disallowed this deduction and assessed a deficiency of taxes and interest of $22,583.78. Taxpayers paid this amount and timely filed a claim for refund which was disallowed November 17, 1971. Taxpayers timely filed this suit on December 21, 1972. The case comes to this court on cross motions for summary judgment. There are no material issues of fact.

"The sole issue in this case is whether at the date of decedent's death the charitable remainder of a trust established under paragraph second of his will had an ascertainable value qualifying such remainder interest for an estate tax

deduction under Section 2055 of the Internal Revenue Code of 1954. With relation to the charitable remainder interests provided in paragraph third of the will, plaintiffs did not claim any charitable deduction.

"The problem which gives rise to this case came about from the language in paragraph seventh, whereby the decedent provided his executors and trustees with these powers:

> (1) To invest in properties whether or not authorized by law for the investment of trust funds;
> (2) To determine conclusively what shall be deemed income or capital; and
> (3) To favor primarily the current life beneficiary.

"Treas. reg. § 20.2055–2 (1958), as material herein provides that the charitable deduction may be allowed

> * * * only insofar as that interest is presently ascertainable, and hence severable from the noncharitable interest.

And with relation to the power to invade it provides

> * * * If the legatee, devisee, donee, or trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, devised, or given by the decedent, the deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of the power. * * *

"The Supreme Court has stated the requirement that a qualifying charitable remainder be presently ascertainable in four major cases. *Commissioner* v. *Estate of Sternberger*, 348 U.S. 187 (1955); *Henslee* v. *Union Planters National Bank & Trust Co.*, 335 U.S. 595 (1949); *Merchants National Bank* v. *Commissioner*, 320 U.S. 256 (1943); *Humes* v. *United States*, 276 U.S. 487 (1928).

In *Merchants National Bank*, *supra*, the Court stated at 261:

> * * * Only where the conditions on which the extent of invasion of the corpus depends are fixed by reference to some readily ascertainable and reliably predictable facts do the amount which will be diverted from the charity and the present value of the bequest become adequately measurable. * * *

"The parties have agreed that insofar as state law is concerned the law of New York applies. We have examined the New York cases cited by plaintiffs and the New York statute. It is our opinion that they are inapposite to the situation herein. Under the facts of this case, we hold that these Supreme Court cases are controlling. The charitable remainder is unascertainable under the requirements prescribed in Treas. Reg. § 20.2055–2 (1958).

CONCLUSION OF LAW

"The defendant's motion for summary judgment is allowed. The plaintiffs' cross motion for summary judgment is denied and the petition is dismissed."

No. 316–74. JANUARY 9, 1976

Reale, Dante S.

Military pay; correction of military records; discretion of correction boards; restoration to active duty; retroactive promotion.—On January 9, 1976 the court issued the following order:

Before SKELTON, *Judge*, Presiding, NICHOLS and KUNZIG, *Judges*.

"This military pay case is before us on cross motions for summary judgment. There is no issue of fact requiring trial. The plaintiff, then a reserve Air Force Captain, was removed from active duty in 1961 for alleged dereliction, by measures we held to be illegal and void in *Reale* v. *United States*, 188 Ct. Cl. 586, 413 F. 2d 556 (1969). We entered judgment for a captain's active duty pay from 1961 to 1969, which has been paid less civilian earnings. Reference may be made to our 1969 opinion for details as to the facts, and for the reasons we decided as we did. Plaintiff has not had any actual active duty since 1961. There was then no question of our doing more for plaintiff than we did, since we had not at that date the authority subsequently conferred by Pub. L. 92–415, 86 Stat. 652 amending 28 U.S.C. § 1491. Plaintiff, however, applied promptly to the Air Force Board for Correction of

Military Records, (established pursuant to 10 U.S.C. Sec. 1552), which did all that was implicit in our decision and a little more. It, or more exactly the Assistant Secretary by its advice, eliminated various derogatory material from plaintiff's record, corrected his record to show active duty as a captain to the date of our decision, a reserve rank of Major from April 13, 1963, without active duty in that rank, and retirement in the rank of Major effective August 1, 1969. Plaintiff however had not requested retirement. He had asked for restoration to active duty in the rank of major, with an opportunity to display his real capabilities.

"Plaintiff also asked the Board for adjustment of pay to his Major's rank, back to 1961, but no longer does so here, thereby mooting a serious question of *res judicata* that defendant had raised. The claim we must adjudicate now relates only to rank, pay and fringe benefits, alleged to have accrued after the date of our former decision. Plaintiff does envisage that our duty to him now is to require active duty pay, with the rank of major until March 13, 1970, when promotion to Lieutenant Colonel became 'mandatory'. Thereafter, we should decree for plaintiff the rank and pay of a Lieutenant Colonel, with active duty as such, though he has never had a day's active duty as major and no real, as distinguished from constructive, military duty of any kind since 1961, over 14 years.

"Our proper function is to decide if the Board abused its authority or was arbitrary and capricious in its decision. Plaintiff erects a castle on sand. He has failed to note or understand the natures of Correction Board jurisdiction, and of ours.

"The Board is to recommend action to correct "error" or 'injustice', 10 U.S.C. § 1552. The two things are not the same. 'Error' means legal or factual error. Normally, it is such that a court of law could correct it whether the soldier or sailor had first applied to a Correction Board, or not. If the Board when asked, fails to correct such an "error", courts will correct it on judicial review. "Injustice", when not also 'error', is treatment by the military authorities, that shocks the sense of justice, but is not technically illegal. *Yee* v. *United States*, 206 Ct. Cl. 388, 512 F. 2d 1383 (1975). Soldiers and sailors

cannot apply directly to courts for correction of 'injustice' that is not 'error'. When they apply to Boards established under 10 U.S.C. § 1552, for correction of such "injustice", these Boards exercise high discretionary functions in the management of the military establishment. Courts are not authorized to intervene except in manifest cases of abuse of discretion, and perhaps not always effectively even then, because they may not have jurisdiction to fashion a satisfactory mode of relief in all cases.

"In applying to the Board for a retroactive promotion, and for restoration to active duty as a major, plaintiff was alleging 'injustice', not 'error'. No soldier has a legal right to a promotion until he receives it. *Doggett* v. *United States*, 207 Ct. Cl. 478 (1975). No reservist has a legal right to be ordered to active duty. *Abruzzo* v. *United States*, 206 Ct. Cl. 731, 513 F.2d 608 (1975). The Board gave plaintiff a retroactive promotion to reserve major because it speculated that he would have been selected, but for his other troubles. A court could not have done this. The Board denied active duty, for less clear reasons, but it cannot be doubted it had in mind the needs of the Service, at that moment, for officers of plaintiff's specialty, and other considerations that courts are not suited to deal with. *Cf.*, Order of June 27, 1975, in *Kaeserman* v. *United States*, 207 Ct. Cl. 983, *cert. denied* 423 U.S. 1050 (1976). In view of all the circumstances, we see no abuse of discretion such as would require us to intervene. What we would have done if authority had been vested in us, is neither here nor there. A Board may, in its discretion, grant a retroactive promotion, without obligating itself to proceed with the fabricating of an entire active duty career. It may grant enough relief to correct what it sees as the injustice and stop there. *Denton* v. *United States*, 204 Ct. Cl. 188, 199 (1974), *cert. denied* 421 U.S. 963 (1975). Plaintiff arguing the contrary, relies on *Motto* v. *United States*, 172 Ct. Cl. 192, 348 F.2d 523 (1965). *Motto* was the product of special circumstances, and it is not now held, if it ever was, that a Board correcting an illegal discharge of a reservist must assume against all reason that the reservist would remain indefinitely on active duty. Motto himself was a regular officer. See explanation of the case in *Denton*, *supra*, at 200.

"Plaintiff sees us as made into a sort of super Correction Board by Pub. L. 92–415, supra. We do not agree. We are given power to order correction of records, and reinstatement but only to make the relief complete as to matters within our jurisdiction, not to exercise discretion for the Service Secretaries and take over the functions of Correction Boards.

"Plaintiff says the Board under 10 U.S.C. § 8911 could not have retired him without his own request. The Board apparently thought from plaintiff's testimony that he was willing to be retired. If one accepts, however, that the Board did not have to give plaintiff further active duty, as we have already held, retirement was in a pecuniary sense the next best thing he could expect. The action was not prejudicial to him, but remedial, and constituted in no way a basis for a money claim. Without a valid money claim, lacking here, a holding that plaintiff was not subject to retirement would be a mere declaratory judgment. *United States* v. *King*, 395 U.S. 1 (1969).

"Plaintiff also says that his long period of actual and constructive active duty as a captain, from 1956 to 1969, constitutes a manifest illegality in face of the 'up or out' laws, and that the illegality should be corrected by further retroactive promotion. The correction, by his theory, requires imputed active duty as a major for a long enough period to make the claimed Lieutenant Colonelcy mandatory as of March 13, 1970. The fallacy of this is that our back pay awards are not and do not pretend to be realistic reconstructions of what the pecuniary consequences of a serviceman's career would have been. They are simply damages by the best measure available. We do not speculate either that the serviceman will be selected for promotion or that he will be 'selected out'. *Gearinger* v. *United States*, 188 Ct. Cl. 512, 412 F.2d 862 (1969). The award may therefore apparently postulate the impossibility that a man may serve 20 years in the same rank, but it does not do so in reality.

"We pass over defendant's invocation of the laches doctrine without discussion, since plantiff fails to prevail on other grounds. Plaintiff makes other contentions that are too strained to be noticed here. His desire for further active service for his country arouses our sympathy, and we regret we are unable to afford him the relief he seeks.

"Plaintiff's motion for summary judgment is denied. Defendant's motion for summary judgment is allowed, and the petition is dismissed."

Plaintiff's motion for rehearing was denied March 26, 1976. On June 21, 1976 plaintiff filed a petition for certiorari.

No. 252–74. JANUARY 9, 1976

Peter P. Calargo, et al.

Employment contract; promotions; Court of Claims jurisdiction; attorneys' fees.—Plaintiffs seek damages, promotions and attorneys' fees in connection with a claimed breach of an alleged employment contract between them and the United States, claiming that certain representations were made to them concerning promotions and salary by employees of the United States prior to their entrance on duty as employees of the Internal Revenue Service and that the United States is bound by such representations under a theory of contract. On January 9, 1976 the court issued the following order:

Before SKELTON, *Judge*, Presiding, NICHOLS and KUNZIG, *Judges*.

"This case comes before the court on defendant's motion, filed April 18, 1975, for summary judgment having been submitted to the court on the briefs and oral argument of counsel. Upon consideration thereof, it appears that no contractual relationship existed between plaintiffs and defendant; that plaintiffs' claims for entitlement to promotions are not within the jurisdiction of this court to grant [See *Keim* v. *United States*, 33 Ct. Cl. 174 (1898), *aff'd* 177 U.S. 290 (1900); *Tierney* v. *United States*, 168 Ct. Cl. 77 (1964); and, *Donnelly* v. *United States*, 133 Ct. Cl. 120, 134 F. Supp. 635 (1955)]; and, that plaintiffs are not entitled to recover for attorneys' fees and costs [See 28 U.S.C. § 2412].

"IT IS THEREFORE ORDERED that defendant's said motion for summary judgment is granted and plaintiffs' petition is dismissed".

Nos. 209–74 AND 211–74. JANUARY 23, 1976

James McConnen & Sons

Contracts; disputes; exhaustion of administrative remedies; redressable and nonredressable claims under contract disputes clause.—On January 23, 1976 the court issued the following order:

Before DAVIS, *Judge*, Presiding, NICHOLS and KASHIWA, *Judges.*

"The record in this case shows that by order of April 4, 1975, Trial Judge Kenneth R. Harkins was willing to have a trial de novo if defendant agreed and was willing to waive its rights for further administrative remedies under the provisions of the "Disputes" article of all of plaintiff's contracts involved. Defendant replied by letter of April 28, 1975, agreeing to a trial and to a waiver of rights to resolve administratively whatever claims might be redressed under the disputes clause of the contracts if plaintiff was willing to similarly waive his rights. By order of the Trial Judge of April 30, 1975, plaintiff was ordered to respond to defendant's letter on or before May 16, 1975. The time was extended to May 30, 1975, by order of May 5, 1975. On May 29, 1975, plaintiff filed his response to defendant's letter stating that he would not renounce the disputes clause of his contracts.

"On July 29, 1975 [reported in full at 21 CCF ¶ 84,149], the Trial Judge rendered an opinion in the above-captioned cases, finding that plaintiff had failed to exhaust the administrative remedies provided by the disputes clause contained in Contract No. F04699–72–C–0194 and Contract No. F04699–72–C–0199, the subject matter of docket Nos. 209–74 and 211–74, respectively.

"By order of the court dated August 29, 1975, plaintiff was allowed until October 15, 1975, to file a brief and request for review of the Trial Judge's recommended decision. Plaintiff has filed numerous motions between September 2, 1975, and November 17, 1975. We construe such motions to be plaintiff's request for review under the rules of the court. Upon consideration thereof and defendant's response thereto,

"IT IS ORDERED that plaintiff's request for review is denied and that the Trial Judge's opinion dismissing plaintiff's petitions without prejudice is adopted."

Nos. 210–74 AND 304–74. JANUARY 23, 1976

James McConnen & Sons

Contracts; disputes; exhaustion of administrative remedies.—On January 23, 1976 the court issued the following order:

Before DAVIS, *Judge*, Presiding, NICHOLS and NASHIWA, *Judges.*

"The record in this case shows that by order of April 4, 1975, Trial Judge Kenneth R. Harkins was willing to have a trial de novo if defendant agreed and was willing to waive its rights for further administrative remedies under the provisions of the "Disputes" article of all of plaintiff's contracts involved. Defendant replied by letter of April 28, 1975, agreeing to a trial and to a waiver of rights to resolve administratively whatever claims might be redressed under the disputes clause of the contracts if plaintiff was willing to similarly waive his rights. By order of the Trial Judge of April 30, 1975, plaintiff was ordered to respond to defendant's letter on or before May 16, 1975. The time was extended to May 30, 1975, by order of May 5, 1975. On May 29, 1975, plaintiff filed his response to defendant's letter stating that he would not renounce the disputes clause of his contracts.

"On July 29, 1975 [reported in full at 21 CCF ¶ 84,149] the Trial Judge rendered an opinion in the above-captioned cases, concluding that plaintiff's petitions should be dismissed without prejudice. The basis of the Trial Judge's decision was that plaintiff's claims involved either independent tort claims over which this court has no jurisdiction or factual allegations so inextricably entwined with claims under the contracts that they cannot be considered separately. Accordingly, the Trial Judge concurred in plaintiff's requested dismissal of docket No. 304–74 and determined that the basic factual issues in docket No. 210–74 would initially have to

be resolved by the Armed Services Board of Contract Appeals under the disputes procedures.

"By order of the court dated August 29, 1975, plaintiff was allowed until October 15, 1975, to file a brief and request for review of the Trial Judge's recommended decision. Plaintiff has since field numerous motions between September 2, 1975, and November 17, 1975. We construe such motions to be plaintiff's request for review under the rules of the court. Upon consideration thereof and defendant's response thereto,

"IT IS ORDERED that plaintiff's request for review of the Trial Judge's opinion is denied and that the Trial Judge's opinion dismissing plaintiff's petitions without prejudice is adopted."

No. 267–74. JANUARY 23, 1976

Carrier Corporation

Patents; third-party practice; motion to quash.—On January 23, 1976 the court issued the following order:

Before DAVIS, *Judge*, Presiding, NICHOLS and KASHIWA, *Judges.*

"This case is before the court on Sunnyvale Truck Co.'s motion to quash the third party notice served on it by the Government on September 18, 1975. The underlying suit is for patent infringement and was heard *en banc* in this court on other aspects on November 3, 1975. Sunnyvale requested that the service be quashed because its participation in the lawsuit would be premature as plaintiff Carrier Corp., has not alleged any infringement by Sunnyvale. Sunnyvale asserts that failure to grant its motion will force it to incur counsel fees and other litigation expenses that cannot be taxed to Carrier Corp., even if it refutes the infringement charge, citing 35 U.S.C. Sec. 285, because Carrier has not yet accused it of anything. Defendant says the motion is mooted because Patent No. 3229627, under which equipment procured from Sunnyvale was accused, has been withdrawn. We do not reach this argument as the motion must be denied on other grounds.

"35 U.S.C. Sec. 285 costs are awarded to the 'prevailing party', which would be the Government in the case supposed in a 28 U.S.C. Sec. 1498 suit in this court. Further, the Section only applies to patent suits in the District Courts. *Regent Jack Mfg. Co.* v. *United States*, 155 Ct. Cl. 222, 225, 292 F. 2d 868, 870 (1961). Thus, the possibility of Sunnyvale getting an award of counsel fees from Carrier Corp., even if specifically accused of infringement is remote. However, if the notice is quashed, the Government's interests may be significantly prejudiced. Sunnyvale furnished machines, in the general area of Carrier's patents, to the Government with the standard indemnity clause which requires a contractor to indemnify the Government for any patent infringement liability arising out of contract performance. The clause is not applicable unless the contractor is informed as soon as practicable by the Government of the suit or action alleging such infringement and is given an opportunity to participate in the defense of the case. Failure to notify Sunnyvale at the outset of the litigation could have adverse consequences on the enforcement of the indemnity clause afterwards. *See*, *Bowser, Inc.* v. *United States*, 190 Ct. Cl. 441, 420 F. 2d 1057 (1970).

"Accordingly, upon consideration of Sunnyvale's motion to quash and defendant's reply thereto, it is ordered that Sunnyvale's motion be denied."

No. 62–75. JANUARY 23, 1976

Felix Pollutro

Limitation of actions; accrual of cause of action.—On January 23, 1976 the court issued the following order:

Before DAVIS, *Judge*, Presiding, NICHOLS and KASHIWA, *Judges*.

"This case comes before the court on defendant's motion for summary judgment, filed July 14, 1975. From January 28, 1941, to January 28, 1949, plaintiff was a deputy collector of the Internal Revenue Service. He was suspended from employment for solicitation of a bribe and acceptance of a gratuity. On July 8, 1949, he was discharged from his position by the Internal Revenue Service.

"Any cause of action that plaintiff may have had accrued as of July 8, 1949, his date of discharge. See *Friedman* v. *United States*, 159 Ct. Cl. 1, 310 F. 2d 381 (1962), *cert. denied*, 373 U. S. 932 (1963); *Middleman* v. *United States*, 91 Ct. Cl. 306 (1940). Plaintiff had six years to assert a claim. 28 U.S.C. § 2501 (1970). His claim was filed in this court on March 3, 1975.

"Upon consideration of defendant's motion for summary judgment, plaintiff's response thereto, defendant's reply, and plaintiff's supplemental memorandum,

"IT IS ORDERED that defendant's motion for summary judgment be and is hereby granted and that plaintiff's petition be and is hereby dismissed."

On June 18, 1976 plaintiff filed a petition for certiorari.

Also on January 23, 1976 the court granted defendant's motion for leave to correct its answer since "justice so requires."

Nos. 103–75, 122–75, 137–75, 151–75, 159–75. JANUARY 23, 1976

Louis G. Ruderer

Judgments; prior adjudication; res judicata.—On January 23, 1976 the court issued the following order:

Before DAVIS, *Judge*, Presiding, NICHOLS and KASHIWA, *Judges*.

"These cases which were consolidated by order of the trial judge on June 24, 1975, come before the court on the defendant's motion to dismiss, pursuant to Rule 38 (b) for failure by the plaintiff to state a claim upon which relief can be granted or over which this court has jurisdiction. Defendant's motion to dismiss is also based on the doctrine of *res judicata*.

"Plaintiff was removed for cause from the Federal service in January 1965. Since that time, he has filed numerous lawsuits contesting the removal. This court, after considering the merits of plaintiff's arguments, upheld the dismissal in *Ruderer* v. *United States*, 188 Ct. Cl. 456, 412 F. 2d 1285 (1969), *cert. denied* 398 U.S. 914 (1970). Plaintiff continued to file lawsuits in the Federal courts seeking damages for injuries due to alleged conspiracies, deprivation of his civil

rights and defamation, all in connection with his removal from the Federal service. The case before us now results from the alleged failure of the United States to answer plaintiff's petitions in five Federal courts, thus according to plaintiff resulting in default judgments. Plaintiff is seeking 2 million dollars in each suit. We hold that plaintiff's suit is barred by the doctrine of *res judicata*.

"In addition, the case must be dismissed because plaintiff has failed to state a claim within the jurisdiction of this court. Plaintiff is essentially asking this court to enter default judgments against the United States for its failure to respond to complaints in other Federal courts. This court is a court of limited statutory jurisdiction which cannot be expanded beyond the limits established by the Congress. *Soriano* v. *United States*, 352 U.S. 270 (1957); *Carney* v. *United States*, 199 Ct. Cl. 160, 462 F. 2d 1142 (1972).

"Plaintiff in this case is asking the court to enter a default judgment against the United States because of its actions in other Federal courts. It is unlikely that plaintiff would be successful in obtaining default judgments in those courts because of Rule 55(e) of the Federal Rules of Civil Procedure which states: 'No judgment by default shall be entered against the United States or an officer or agency thereof unless the claimant establishes his claim or right to relief by evidence satisfactory to the court.' Plaintiff has not shown that he is entitled to recovery on the underlying merits of his claim; in fact, in light of this court's prior ruling in 188 Ct. Cl. 456, it is dubious that plaintiff has any valid claim at all. If the claims are regarded as "independent actions" under Rule 152(b), we lack jurisdiction under authority of *Carney*, *supra*.

"Plaintiff has filed motions for summary judgment, a motion to restrain the defendant's operation of Acts of Congress in repugnance to the Constitution, a motion to amend order for consonance with practices and for mooting of issue pending for review, a motion for declaratory judgment, a motion for immediate adjudication and a motion for the court to recognize the pendency of provisions of Rule 101 (a). In view of our decision to grant defendant's motion to

dismiss, plaintiff's motions are denied, as are any other motions plaintiff has filed before this date, not previously acted on. The defendant is not obliged to respond to plaintiff's interrogatories and, henceforward, defendant is not required to respond to any paper filed by plaintiff in these cases unless specifically ordered to do so by the court.

"Upon consideration thereof, without oral argument, IT IS ORDERED THAT plaintiff's motion be denied and that defendant's motion to dismiss with prejudice be granted and the five suits enumerated above are dismissed with prejudice."

Plaintiff's suggestion for rehearing *en banc* and motion for rehearing were denied February 27, 1976, and plaintiff's motion to set aside judgment, etc. was denied June 25, 1976.

No. 183–75. JANUARY 23, 1976

Marie A. Porter

Court of Claims jurisdiction; employee of the District of Columbia; suit for back pay.—On January 23, 1976 the court issued the following order:

Before DAVIS, *Judge*, Presiding, NICHOLS and KASHIWA, *Judges.*

"This case comes before the court on defendant's motion to dismiss, filed September 29, 1975. Plaintiff is a former employee of the Government of the District of Columbia and is seeking recovery of back pay from the United States. The Court of Claims is without jurisdiction. The District of Columbia is not an agency or instrumentality of the United States and the Federal Government is not liable for the actions of the District. *John McShain, Inc.* v. *United States*, 179 Ct. Cl. 632, 375 F. 2d 829 (1967); *Sweeney* v. *United States*, 152 Ct. Cl. 516, 285 F. 2d 444 (1961). Employees of the District of Columbia are not employees of the United States. Upon consideration of defendant's motion to dismiss, plaintiff's brief in opposition thereto, and defendant's reply to plaintiff's opposition.

"IT IS ORDERED that defendant's motion to dismiss is granted and plaintiff's petition is dismissed."

No. 242–75. JANUARY 23, 1976

C. R. Wilhite

Military pay; readjustment pay for reservist; release from active duty.—On January 23, 1976 the court issued the following order:

Before DAVIS, *Judge*, Presiding, NICHOLS and KASHIWA, *Judges.*

"This case comes before the court on defendant's motion for summary judgment, filed September 30, 1975. The issue involved is the determination of the number of years of continuous active duty required of a reservist in order for him to be eligible for readjustment pay under 10 U.S.C. § 687(a) (1970). The question was answered by the Supreme Court when it stated in *Cass* v. *United States*, 417 U.S. 72, 84 (1974):

> We thus conclude that the rounding provision of § 687(a)(2) is applicable only in the determination of how much readjustment pay an otherwise qualified reservist is authorized, and that such a reservist must serve a minimum of five full years of continuous active duty before he is involuntarily released in order to be eligible for readjustment benefits. * * *

Since plaintiff did not serve five full years of continuous active duty,

"IT IS ORDERED that defendant's motion for summary judgment be and is hereby granted. Plaintiff's petition is dismissed."

No. 308–75. JANUARY 23, 1976

John R. Carlson and Eleanor O. Carlson

Court of Claims jurisdiction; suit to try title to land; just compensation.—On January 23, 1976 the court issued the following order:

Before DAVIS, *Judge*, Presiding, NICHOLS and KASHIWA, *Judges.*

"This case is before the court on defendant's motion to dismiss on the grounds that the petition fails to state a claim upon which relief can be granted. Plaintiffs are owners in fee simple of a tract of land in Snohomish County, Washington, which borders on the Tulalip Indian Reservation. Plaintiffs brought an action in the United States District Court to quiet title to the tract, naming the Tulalip Tribe as defendant. Plaintiff attempted to join the United States as an indispensable party; the United States asserted sovereign immunity and refused consent to be sued. The District Court, on July 16, 1973, dismissed the action with prejudice for want of the United States as an indispensable party and the Court of Appeals affirmed. *Carlson* v. *Tulalip Tribes of Washington*, 510 F. 2d 1337 (9th Cir. 1975). Plaintiffs now contend that the refusal of the United States to consent to suit in a quiet title action constitutes an unconstitutional taking pursuant to the Fifth Amendment to the Constitution entitling plaintiff to just compensation in the amount of $80,000.

"In dismissing an ejectment action for want of the United States as an indispensable party, the Supreme Court has recognized, albeit in a footnote, the Court of Claims as an appropriate tribunal where plaintiffs could try title by seeking just compensation for the taking of their land by the United States. *Malone* v. *Bowdoin*, 369 U.S. 643, 647, fn. 8, (1962). We are unwilling to dismiss a petition on motion at this stage of the proceedings because the allegations of the petition may state a cause of action under some possible readings. The interest of the United States in the land at issue in this case is unclear and accordingly, defendant's motion to dismiss is denied without prejudice."

No. 680–71. JANUARY 30, 1976

Burlington Northern, Inc.

Carriers; rates, fares and charges; classification of goods; grained ammonium nitrate.—Plaintiff seeks additional compensation for freight transportation of grained ammonium nitrate on Government bills of lading. Plaintiff contends that

the shipments should be rated under Item 22400 of the Uniform Freight Classification under the heading "Chemicals" and defendant contends that the shipments should be rated under various fertilizer and general commodity tariffs. On March 27, 1975 Senior Trial Judge Mastin G. White filed a memorandum opinion concluding, for the reasons stated in the recommended opinion, findings of fact and conclusion of law filed March 25, 1975 in the companion case of *Union Pac. R.R.* v. *United States*, No. 688–71 [decided by the court on February 18, 1976 and reported at 209 Ct. Cl. 83, 530 F. 2d 322], that the grained ammonium nitrate was properly ratable as a chemical, and that plaintiff was entitled to recover. On January 30, 1976, following the filing of defendant's exceptions to the recommended decision, briefs and oral argument of counsel, the court (Cowen, *Chief Judge*, Durfee, *Senior Judge*, and Kunzig, *Judge*), by order, adopted and affirmed the said decision as the basis for its judgment in this case, concluded that plaintiff is entitled to recover and entered judgment for plaintiff against defendant for $552,733.98.

No. 173–72. JANUARY 30, 1976

Wagner Electric Corporation

Taxes; income tax; losses; subsidiary's debts to parent v. *capital contributions by parent.*—On January 30, 1976 the court issued the following order:

Before COWEN, *Chief Judge*, DAVIS and KASHIWA, *Judges*.

"This income tax case, involving the tax year 1965, comes before the court on defendant's exceptions to Trial Judge Charlotte P. Murphy's recommended decision, conclusion of law, and findings of fact, which were filed on May 16, 1975 and have been supplied to the parties [reported in full at 75–1 USTC ¶ 9471 and at 36 AFTR ¶ 75–5898]. The court has had oral argument and has considered the briefs.

"The case raises the question whether (1) cash advances by a Delaware corporation to a subsidiary organized and operating in Canada were loans (as contended by taxpayer) or capital contributions (as urged by defendant), and (2) in-

tercompany transactions between parent and subsidiary, called an 'open account' by the companies and said to represent indebtedness for sales by the parent to the subsidiary and for temporary loans of personnel, represented debts to the parent or capital contributions by it. The trial judge ruled in favor of the taxpayer on both questions. The Government does not except to the holding that the initial advances in 1961–1962 of $1,000,000, evidenced by an interest bearing note, represented a true loan. Instead the defendant now concentrates on the $778,348 in open account advances made in the period December 1, 1963 through September 13, 1965, arguing that those advances were in fact capital contributions.

"On all the facts and circumstances set forth in the trial judge's findings of fact the court agrees with the trial judge's conclusion and generally with the main strands of the reasoning in her opinion. Though the question is not open and shut, the court finds and determines, without adopting the trial judge's opinion *in haec verba*, that (1) the initial advances in 1961–1962 represented indebtedness from the Canadian subsidiary (Ltd.) to the American parent (Tung-Sol, now Wagner Electric Corporation), and (2) the open account from December 1, 1963 through September 13, 1965, also created a debt by the subsidiary to the parent.

"Accordingly, on the trial judge's findings of fact which are adopted by the court and made part of the judgment herein, the court concludes as a matter of law that the plaintiff is entitled to recover, and judgment is entered to that effect, with the amount of recovery to be determined in further proceedings under Rule 131(c)."

No. 450–72. JANUARY 30, 1976

Northland Camps Incorporated

Contracts; interpretation; place of acceptance; remand to Board re computation of damages not necessary.—This case has been the subject of an earlier opinion of this court reported at 204 Ct. Cl. 761, 499 F. 2d 658 (1974), the case being remanded to the trial division for further proceedings. On September 17, 1975 Trial Judge Thomas J. Lydon filed a

recommended decision (reported in full at 21 CCF para. 84,238). In controversy was the place where final acceptance of the trailers by the Government was to take place in view of a contract modification. The trial judge concluded that the modification changed the point of final acceptance from plaintiff's plant in Idaho to final destination in Kwajalein. In revising the Board's *method* of computing damages, the trial judge concluded that since the damage figures used are all derived from the Board's record so that no further trial proceedings were required, remand to the Board appeared to be an empty ritual and unnecessary. Following filing of the recommended decision, the parties jointly moved that the court adopt the said decision. On January 30, 1976 the court (Davis, *Judge*, Presiding, Nichols and Kashiwa, *Judges*) by order, granted the motion and adopted the said decision as the basis for its judgment in this case. The order also reads in part:

"IT IS THEREFORE CONCLUDED AND ORDERED that with respect to plaintiff's claim and defendant's second counterclaim, neither party has established that the decision of the Armed Services Board of Contract Appeals was legally erroneous, arbitrary, capricious, or unsupported by substantial evidence and, accordingly, plaintiff's petition and defendant's second counterclaim are dismissed.

"IT IS FURTHER CONCLUDED AND ORDERED that with respect to damages which are the subject of defendant's first counterclaim, plaintiff has established that the Board's quantum determinations are partially erroneous as a matter of law and that defendant's net entitlement under the first counterclaim is limited to $2,687. Accordingly, judgment is entered for the defendant on its first counterclaim against the plaintiff in the sum of two thousand six hundred and eighty-seven dollars ($2,687.00)."

No. 84–73. JANUARY 30, 1976

Simonson Lumber Company

Eminent domain; taking; just compensation; interest; litigation expenses; Redwoods National Park Act.—Plaintiff seeks to recover just compensation and litigation ex-

penses it incurred growing out of appropriation of its property by defendant pursuant to Pub. L. 90–545. It is conceded that plaintiff is entitled to just compensation from defendant for the property taken. On May 8, 1975 Trial Judge Thomas J. Lydon filed a recommended decision respecting the measure of just compensation, including severance damages. On January 30, 1976 the court issued the following order:

Before SKELTON, *Judge*, Presiding, NICHOLS and BENNETT, *Judges.*

"This case comes before the court on exceptions by the parties to the recommended decision of Trial Judge Thomas J. Lydon, filed May 9, 1975, having been submitted on the briefs and oral argument of counsel. Upon consideration thereof, since the court agrees with the trial judge's recommended decision, copies of which have been furnished to the parties, it hereby affirms and adopts the said decision as the basis for its judgment in this case.

"IT IS THEREFORE CONCLUDED AND ORDERED that plaintiff is entitled to judgment and judgment is entered for plaintiff against defendant for just compensation for the taking by defendant of some 32.74 acres of plaintiff's land on October 2, 1968, in the sum of eighty-four thousand five hundred dollars ($84,500), with interest as part of just compensation at the rate of six (6) percent per annum from October 2, 1968, until paid, provided that plaintiff may obtain payment of such award only upon tender of a deed to such property in such form as the Attorney General may deem necessary to assure the defendant a valid fee simple title free of all encumbrances.

"IT IS FURTHER ORDERED that judgment be and the same is hereby entered denying recovery of litigation expenses by plaintiff."

APP. NO. 13–74. JANUARY 30, 1976

The Hopi Tribe

Indians; appeal from Indian Claims Commission; overlapping land claims.—On January 30, 1976 the court issued the following order:

Before SKELTON, *Judge*, Presiding, NICHOLS and BENNETT, *Judges*.

"In this case the Navajo Tribe filed a petition with the Indian Claims Commission on July 11, 1950, in which it claimed the taking of a substantial amount of land to which it had aboriginal title by the United States and sought just compensation for the same. *Navajo Tribe* v. *United States*, Docket No. 229. In like manner the Hopi Tribe filed a similar suit on August 8, 1951, seeking compensation for the taking of land by the United States to which it claimed aboriginal title. *Hopi Tribe* v. *United States*, Docket No. 196. Inasmuch as the land claimed by these tribes in these suits overlapped, the Commission consolidated the cases and tried them together. On June 29, 1970, the Commission determined the area to which each tribe had aboriginal title and made findings of fact and entered an interlocutory order in the consolidated case. 23 Ind. Cl. Comm. 277. Thereafter, the Hopi Tribe filed a motion for further hearings on the dates of taking, and for a rehearing and for amendment of the findings of the Commission. The Commission granted a hearing and permitted the filing of documentary evidence and exhibits and thereafter denied the motion to amend its findings. 31 Ind. Cl. Comm. 16 (1973) and 33 Ind. Cl. Comm. 72 (1974).

"The Hopi Tribe appealed to this court in the present suit from the decisions, findings, and orders of the Commission. The Navajo Tribe and the United States did not appeal.

"After consideration of the record, the briefs, and oral argument of counsel, the court concludes that the findings made by the Commission support its decisions and orders and the same are supported by substantial evidence.

"We conclude further that there is no error of law in the decisions of the Commission and that the same should be affirmed.

"Accordingly, the decisions and orders of the Commission are approved and affirmed, and the case is remanded to the Commission for further proceedings in accordance with this order."

Appellant's motion for rehearing and suggestion for rehearing *en banc* were denied March 26, 1976.

APP. No. 20–74. JANUARY 30, 1976

The Nisqually, S'Homamish, Stehchass, T'Peeksin, Squiatl, and Sa-heh-wamish Tribes or Indians

Indian claims; appeal from Indian Claims Commission; "one nation"; Treaty of Medicine Creek.—On January 30, 1976 the court issued the following order:

Before SKELTON, *Judge*, Presiding, NICHOLS and BENNETT, *Judges.*

"This is an appeal by the Nisqually Tribe of Indians from a decision of the Indian Claims Commission, 21 Ind. Cl. Comm. 173 (1969), Docket No. 197. The suit was originally filed by the Nisqually, S'Homamish, Stehchass, T'Peeksin, Squiatl, and Sa-heh-wamish Tribes of Indians, however, all of these tribes have disappeared and no longer exist except the Nisqually Tribe which is involved in this appeal. At the time this suit was filed in 1951, the same attorney filed three other cases, all of which are related, and all of which were decided by the Indian Claims Commission on the same evidence and the same record; namely, Docket No. 208, *Steilacoom Tribe* v. *United States*, 11 Ind. Cl. Comm. 304 (1962); Docket No. 203, *Puyallup Tribe* v. *United States*, 17 Ind. Cl. Comm. 1 (1966); Docket No. 206, *Squaxin Tribe* v. *United States*, 21 Ind. Cl. Comm. 295 (1969). In each of these cases the plaintiff tribe alleged that it had aboriginal Indian title to the exclusion of all other tribes of certain designated land described in its petition. Although the cases were not consolidated, they were tried together, and, as indicated above, decisions of the Commission were made on the same evidence and the same record. The trial was held at various hearings between 1952 and 1954. At the trial all of the tribes produced evidence showing that they were separate and distinct individual tribes and that each of them had aboriginal title to certain described lands to the exclusion of all other Indian tribes. The various tribes produced expert witnesses who gave evidence to this effect. The evidence was closed in 1954 and five years later, in 1959, the attorney for all of these tribes filed a motion with the Commission to con-

solidate all of the cases and for the first time raised the issue that the tribes were not single individual tribes but were one nation because of the language used in the 1854 Treaty of Medicine Creek between them and the United States and five other tribes mentioned in the Treaty (9 tribes in all). In such motion, the plaintiff tribes allege that the Treaty stated, after naming the nine tribes, that 'for the purpose of this treaty are to be regarded as one nation' and that this language made them one nation as a matter of law and by reason thereof they were entitled to just compensation for more land than was awarded to them by the Commission as separate individual tribes. The Commission denied the motion to consolidate. Plaintiff tribes never at any time thereafter moved to exclude or withdraw from the record the evidence they had produced showing that they were separate individual tribes owning and possessing separate aboriginal Indian title to specific lands to the exclusion of all other tribes. The plaintiff tribes did not preserve the 'one nation' theory by requesting any findings of the Commission that they were one nation. The Commission made its findings that these tribes were not one nation, but were in fact separate individual tribes and that each of them had aboriginal title to certain described lands to the exclusion of all other tribes.

"In the instant case, the Nisqually Tribe has appealed to this court from the decision of the Indian Claims Commission on the theory that it and the other mentioned tribes were one nation because of the language in the Treaty of Medicine Creek and that by reason thereof, they are entitled to just compensation for all of the land involved in said Treaty instead of the smaller area awarded to it as an individual tribe by the Commission.

"After consideration of the record, the briefs, and oral argument of counsel, the court concludes that the plaintiff was far too late in raising the 'one nation' theory five years after the evidence and the record had been closed, especially in view of the allegations in the petition and the proof which it produced at the trial that it was an individual tribe instead of a member of a nation, and especially in view of the fact that it never withdrew said evidence which it produced at the trial and never produced any evidence that it was a member

of a nation of Indian tribes and never requested any findings to that effect.

"The court concludes that the findings as made support the decision of the Commission and the same is supported by substantial evidence.

"We further conclude that there is no error of law in the decision of the Commission and that the same should be affirmed.

"Accordingly, the decision of the Commission is approved and affirmed and the case is remanded to the Commission for further proceedings in accordance with this order."

APP. NO. 21–74. JANUARY 30, 1976

The Squaxin Tribe of Indians

Indian claims; appeal from Indian Claims Commission; "one nation"; Treaty of Medicine Creek.—On January 30, 1976 the court issued the following order:

Before SKELTON, *Judge*, Presiding, NICHOLS and BENNETT, *Judges*.

"This is an appeal by the Squaxin Tribe of Indians from a decision of the Indian Claims Commission, 21 Ind. Cl. Comm. 295 (1969), Docket No. 206. At the time this suit was filed in 1951, the same attorney filed three other cases, all of which are related, and all of which were decided by the Indian Claims Commission on the same evidence and the same record; namely, Docket No. 208, *Steilacoom Tribe* v. *United States*, 11 Ind. Cl. Comm. 304 (1962); Docket No. 203, *Puyallup Tribe* v. *United States*, 17 Ind. Cl. Comm. 1 (1966); and Docket No. 197, *Nisqually Tribe* v. *United States*, 21 Ind. Cl. Comm. 173 (1969). In each of these cases the plaintiff tribe alleged that it had aboriginal Indian title to the exclusion of all other tribes of certain designated land described in its petition. Although the cases were not consolidated, they were tried together, and, as indicated above, decisions of the Commission were made on the same evidence and the same record. The trial was held at various hearings between 1952 and 1954. At the trial all of the tribes produced

evidence showing that they were separate and distinct individual tribes and that each of them had aboriginal title to certain described lands to the exclusion of all other Indian tribes. The various tribes produced expert witnesses who gave evidence to this effect. The evidence was closed in 1954 and five years later, in 1959, the attorney for all of these tribes filed a motion with the Commission to consolidate all of the cases and for the first time raised the issue that the tribes were not single individual tribes but were one nation because of the language used in the 1854 Treaty of Medicine Creek between them and the United States and five other tribes mentioned in the Treaty (9 tribes in all). In such motion, the plaintiff tribes allege that the Treaty stated, after naming the nine tribes, that 'for the purpose of this treaty are to be regarded as one nation' and that this language made them one nation as a matter of law and by reason thereof they were entitled to just compensation for more land than was awarded to them by the Commission as separate individual tribes. The Commission denied the motion to consolidate. Plaintiff tribes never at any time thereafter moved to exclude or withdraw from the record the evidence they had produced showing that they were separate individual tribes owning and possessing separate aboriginal Indian title to specific lands to the exclusion of all other tribes. The plaintiff tribes did not preserve the 'one nation' theory by requesting any findings of the Commission that they were one nation. The Commission made its findings that these tribes were not one nation, but were in fact separate individual tribes and that each of them had aboriginal title to certain described lands to the exclusion of all other tribes.

"In the instant case, the Squaxin Tribe has appealed to this court from the decision of the Indian Claims Commission on the theory that it and the other mentioned tribes were one nation because of the language in the Treaty of Medicine Creek and that by reason thereof, they are entitled to just compensation for all of the land involved in said Treaty instead of the smaller area awarded to it as an individual tribe by the Commission.

"After consideration of the record, the briefs, and oral argument of counsel, the court concludes that the plain-

tiff was far too late in raising the 'one nation' theory five years after the evidence and the record had been closed, especially in view of the allegations in the petition and the proof which it produced at the trial that it was an individual tribe instead of a member of a nation, and especially in view of the fact that it never withdrew said evidence which it produced at the trial and never produced any evidence that it was a member of a nation of Indian tribes and never requested any findings to that effect.

"The court concludes that the findings as made support the decision of the Commission and the same is supported by substantial evidence.

"We further conclude that there is no error of law in the decision of the Commission and that the same should be affirmed.

"Accordingly, the decision of the Commission is approved and affirmed and the case is remanded to the Commission for further proceedings in accordance with this order."

APP. No. 22–74. JANUARY 30, 1976

The Steilacoom Tribe of Indians

Indian claims; appeal from Indian Claims Commission; "one nation"; Treaty of Medicine Creek.—On January 30, 1976 the court issued the following order:

Before SKELTON, *Judge*, Presiding, NICHOLS and BENNETT, *Judges*.

"This is an appeal by the Steilacoom Tribe of Indians from a decision of the Indian Claims Commission, 11 Ind. Cl. Comm. 304 (1962), Docket No. 208. At the time this suit was filed in 1951, the same attorney filed three other cases, all of which are related, and all of which were decided by the Indian Claims Commission on the same evidence and the same record; namely, Docket No. 197, *Nisqually Tribe* v. *United States*, 21 Ind. Cl. Comm. 173 (1969); Docket No. 203, *Puyallup Tribe* v. *United States*, 17 Ind. Cl. Comm. 1 (1966); Docket No. 206, *Squaxin Tribe* v. *United States*, 21 Ind. Cl. Comm. 295 (1969). In each of these cases the

plaintiff tribe alleged that it had aboriginal Indian title to the exclusion of all other tribes of certain designated land described in its petition. Although the cases were not consolidated, they were tried together, and, as indicated above, decisions of the Commission were made on the same evidence and the same record. The trial was held at various hearings between 1952 and 1954. At the trial all of the tribes produced evidence showing that they were separate and distinct individual tribes and that each of them had aboriginal title to certain described lands to the exclusion of all other Indian tribes. The various tribes produced expert witnesses who gave evidence to this effect. The evidence was closed in 1954 and five years later, in 1959, the attorney for all of these tribes filed a motion with the Commission to consolidate all of the cases and for the first time raised the issued that the tribes were not single individual tribes but were one nation bebecause of the language used in the 1854 Treaty of Medicine Creek between them and the United States and five other tribes mentioned in the Treaty (9 tribes in all). In such motion, the plaintiff tribes allege that the Treaty stated, after naming the nine tribes, that 'for the purpose of this treaty are to be regarded as one nation' and that this language made them one nation as a matter of law and by reason thereof they were entitled to just compensation for more land than was awarded to them by the Commission as separate individual tribes. The Commission denied the motion to consolidate. Plaintiff tribes never at any time thereafter moved to exclude or withdraw from the record the evidence they had produced showing that they were separate individual tribes owning and possessing separate aboriginal Indian title to specific lands to the exclusion of all other tribes. The plaintiff tribes did not preserve the 'one nation' theory by requesting any findings of the Commission that they were one nation. The Commission made its findings that these tribes were not one nation, but were in fact separate individual tribes and that each of them had aboriginal title to certain described lands to the exclusion of all other tribes.

"In the instant case, the Steilacoom Tribe has appealed to this court from the decision of the Indian Claims Commission on the theory that it and the other mentioned tribes

were one nation because of the language in the Treaty of Medicine Creek and that by reason thereof, they are entitled to just compensation for all of the land involved in said Treaty instead of the smaller area awarded to it as an individual tribe by the Commission.

"After consideration of the record, the briefs, and oral argument of counsel, the court concludes that the plaintiff was far too late in raising the 'one nation' theory five years after the evidence and the record had been closed, especially in view of the allegations in the petition and the proof which it produced at the trial that it was an individual tribe instead of a member of a nation, and especially in view of the fact that it never withdrew said evidence which it produced at the trial and never produced any evidence that it was a member of a nation of Indian tribes and never requested any findings to that effect.

"The court concludes that the findings as made support the decision of the Commission and the same is supported by substantial evidence.

"We further conclude that there is no error of law in the decision of the Commission and that the same should be affirmed.

"Accordingly, the decision of the Commission is approved and affirmed and the case is remanded to the Commission for further proceedings in accordance with this order."

No. 185–74. JANUARY 30, 1976

Philip D. Coates

Civilian pay; dismissal; oral or written reply to charges; penalty.—On January 30, 1976 the court issued the following order:

Before SKELTON, *Judge*, Presiding, NICHOLS and BENNETT, *Judges.*

"This case is before us on cross motions for summary judgment. The plaintiff was an Air Traffic Control Specialist with the FAA. He had a problem arriving at work on time, including the few minutes required to familiarize himself with the air traffic situation before taking over the

controls at the start of his shift. This weakness was viewed as more serious because of the peculiar nature of FAA work. Plaintiff was cautioned, officially warned, reprimanded, suspended for five days, and, ultimately removed from his position. The latter action only is before us for review in the present case. Plaintiff has exhausted his administrative remedies and the suit is timely brought.

"The court has carefully considered the record, the briefs, and the oral arguments. We conclude that there is no issue of material fact for trial. The case is appropriate for summary judgment. The only procedural issue requiring discussion is plaintiff's argument, citing *Ricucci* v. *United States*, 192 Ct. Cl. 1, 425 F. 2d 1252 (1970), on motion for reconsideration, 193 Ct. Cl. 120, 432 F. 2d 453 (1970), that he was denied the opportunity for an oral or written 'reply' to the charges preferred by the agency.

"The notice of proposed removal allowed plaintiff fifteen days to submit his 'reply'. On the fourteenth day, he submitted a paper captioned:

> Reply to Letter of Proposal to Remove Philip D. Coates from Service, Dated 10 May, 1972.

The first paragraph read:

> This letter is in reply to your proposed removal of me in accordance with the 15-day period as explained in your letter.

The memo or letter goes on to admit, in effect, that the 'indicated pattern of unreliability' was true, but says the writer has sought psychiatric help and learned 'many things about myself that I have not been aware of including a personality disorder * * *'. He says he plans therapy sessions and asks 'an extension of time for your final decision of not less than 60 days, and more if possible * * *'. In support of this request he submits a 'To whom it may concern' letter by a psychiatrist, Dr. John Douglas, stating: Mr. Coates has consulted him, that he 'suffers from a personality disorder which is manifest in self-defeating behavior,' that such traits are 'slow but not impossible to change' and that he hopes 'at least a six month trial of therapy be granted before a definitive decision be reached * * *.'

"Plaintiff says this is not the 'reply' but a request for an extension of time in which to reply. If it appears to be the 'reply' itself, this is due to plaintiff's having composed the paper *pro se*, not having as yet retained counsel. The agency, however, took it as the 'reply' and the plain meaning of the document seems to support that position. It says it is a 'reply' in conformity with the 15-day period. There is not a word to advise the agency to expect further oral or written material refuting the charges. In substance they are admitted, but instead of dismissal, what is in effect a probationary period is asked for, the duration of which would need to be upwards of 60 days according to plaintiff an upwards of six months according to the perhaps more expert judgment of the psychiatrist. The agency, therefore, rightly concluded it had received its 'reply' and that the case was ripe for the agency decision which was shortly forthcoming. We see no procedural error here.

"With respect to the substance of the case, the plaintiff urges that dismissal was too severe a penalty. The agency's published table of penalties, however, provided for 'a pattern of frequent lateness for duty (excessive tardiness)' a penalty of '30 days suspension to removal' in case of a third offense. In the context of this litigation, we have a third offense, the previous reprimand and suspension constituting penalties as prescribed in the table for the first two offenses. It will be noted that the 'offense' is a 'pattern', not a single instance of lateness. Should we believe plaintiff had made a persuasive case for a penalty at the lenient side of the range, we would be compelled to admit that we are in no position to determine judicially what measures are necessary 'for the efficiency of the service' in this if in any context. The stresses on FAA Controllers are well known to everyone, and it could well seem too much for fellow controllers to be asked to remain overtime intermittently at their posts to accommodate plaintiff's tardiness over the six months, or longer, period, the therapy was to require to demonstrate improvement.

"Accordingly, the Board of Appeals and Review decision before us is supported by substantial evidence and is not arbitrary, capricious, or contrary to law. Plaintiff's motion for summary judgment is denied. Defendant's motion for summary judgment is granted. The petition is dismissed."

Plaintiff's motion for rehearing or alteration of judgment was denied March 26, 1976.

No. 256–74. JANUARY 30, 1976

Richard G. Polse

Military pay; allowances; quarters allowance.—On January 30, 1976 the court issued the following order:

Before SKELTON, *Judge*, Presiding, NICHOLS and BENNETT, *Judges*.

"This case, before the court on motions by the parties for summary judgment, presents the question of whether an enlisted member of the United States Army Reserve who does not have any dependents is entitled to a Basic Allowance for Quarters (BAQ) at the dependent rate when on active duty for training although he was furnished Government quarters. The essential facts are undisputed.

"Plaintiff, who served as an enlisted member of the 861st Transportation Company, Oakland Army Base, California, is claiming BAQ at the 'with dependents' rate for two 14-day tours of active duty for training in 1973 and 1974, respectively. Plaintiff is unmarried and has no dependents. His application for such allowance for 1973 was disallowed administratively. He made no application for the 1974 allowance on this account. The rejection by the Army Finance Support Agency was because 'Department of Defense Regulations state that BAQ does not accrue for members ordered to active duty for training, for any period he occupies government quarters.' We note that statutory and regulatory distinctions are made between service members without a dependent and those with a dependent. A dependent can be a spouse, an unmarried child, or a parent. An unmarried service member therefore can have a dependent and draw an allowance therefor. 37 U.S.C. §§ 401, 403 (1970). The parties are in agreement that the statute and regulations prevent the BAQ allowance for service members with dependents if Government quarters are furnished to them without charge. They further agree that for short 2-week tours of duty dependents are not authorized to accompany Reservists. But,

the Reservist with dependents nevertheless is entitled to BAQ, although he lives in Government quarters and his dependents remain at home. Plaintiff challenges this practice as patently arbitrary, illegal, and without rational relationship to any legitimate governmental interest. He charges that it is unlawful, unconstitutional discrimination against the unmarried Reservist. This, he says, is because in either event the Reservist must maintain at personal expense his civilian living quarters during active duty training.

"The difficulty with plaintiff's approach is his assumption that BAQ entitlement is supposed to be reimbursement for housing regardless of dependents and that marriage, not dependency in the present case, is the crucial factor. He objects to the cases that hold there is an automatic right to the additional allowances for dependents regardless of the actual fact of dependency claimed, and based only upon the presumption of the statutes and regulations. While it is true by definition of dependent, 37 U.S.C. § 401 (1970), all married persons in the service can qualify as persons with dependents, this does not discriminate against unmarried members because they too can have dependents. The allowance thus runs to the dependent, not to marital status per se, as plaintiff claims. The distinctions in the statutes and regulations are solely between service members with and without dependents. 37 U.S.C. § 403 (1970). *Adams* v. *United States*, 106 Ct. Cl. 209, 65 F. Supp. 86 (1946). This is true whether the service member is a Reservist or Regular. We believe that the statute bears a rational relation to a legitimate, permissible, legislative goal of insuring housing for dependents and is constitutional. We find no invidious discrimination against this plaintiff. This requires us to uphold the classification made by the statute. It is unnecessary to reach other points raised by the parties. Entitlement to the BAQ is based solely on the existence of dependents and not on whether or not a Reservist is married. As a Reservist without dependents plaintiff does not qualify for the allowance. Only Congress can change the statute.

"IT IS THEREFORE ORDERED that, upon consideration of the petition and answer, the defendant's motion for summary judgment and plaintiff's cross-motion, defendant's response,

the administrative record, and upon oral argument, defendant's motion is granted and plaintiff's cross-motion is denied. The petition is dismissed."

No. 125–75. JANUARY 30, 1976

Norma J. Borgford

Military pay; release from active duty; passovers for promotion; reservist; Court of Claims jurisdiction re promotions.—On January 30, 1976 the court issued the following order:

Before DAVIS, *Judge*, Presiding, NICHOLS and KASHIWA, *Judges.*

"This case comes before the court on defendant's motion, filed July 18, 1975, to dismiss plaintiff's petition having been considered, together with plaintiff's opposition thereto, without oral argument.

"Plaintiff is a nurse who has served as an air force reserve officer for many years. She has career reserve status, and was on extended active duty during 1957–1960 and 1963–1973. She was a captain in the latter part of her service. After having twice been passed over (in 1971 and 1972) by selection boards for promotion to major, she was released from extended active duty on April 30, 1973, by reason of that failure of selection for promotion. Her administrative appeals within the Air Force to void the passovers (including applications to the Air Force Board for the Correction of Military Records) were denied and she has filed this suit. The primary basis of her claim is that it was arbitrary and capricious for the Correction Board not to void certain Officer Effectiveness Reports considered by the selection boards, and therefore arbitrary and capricious not to overturn the 1971 and 1972 passovers. She seeks (a) promotion to, payment as, and placement as, a major, and (b) at the least, continued payment as a captain on extended active duty and reinstatement in that position.

"Defendant has not moved for summary judgment but has instead moved to dismiss the petition solely on the grounds that (1) even if the Air Force authorities acted improperly

or abused their discretion in the process of passing her over for promotion, plaintiff has no legal right to reinstatement and backpay as a reserve captain because reserve officers are subject, under 10 U.S.C. § 681(a), to release from active duty at any time within the service's full and untrammeled discretion, and (2) this court has no jurisdiction to entertain plaintiff's claim for promotion to major or, in any event, that claim is not one on which relief can be granted.

"With respect to the claim for reinstatement and backpay as a captain, the court holds that in establishing the career reserve system, designating the particular grounds on which such career reservists may be released from extended active duty (including failure of promotion), and specifying one of those grounds (failure of promotion) as the reason for plaintiff's release from extended active duty, the Air Force limited its otherwise plenary discretion under 10 U.S.C. § 681 (a), so that plaintiff is entitled to appropriate judicial review of the specific ground given for her release. *Cf. Service* v. *Dulles*, 354 U.S. 363, 380, 386–87, 388 (1957); *Vitarelli* v. *Seaton*, 359 U.S. 535, 539–40, 546–47 (1959); and, *Watson* v. *United States*, 142 Ct. Cl. 749, 162 F. Supp. 755 (1958). Defendant has not filed a motion for summary judgment or made any effort to show the reasonableness of the Air Force's determination that the passovers in 1971 and 1972 should not be voided. Accordingly, defendant's motion to dismiss is denied with respect to plaintiff's claim for backpay and reinstatement as a captain, without prejudice to the filing of a motion for summary judgment or other means of testing whether the Air Force acted improperly or abused its discretion in passing plaintiff over for selection for promotion.

"With respect to the claim for promotion to major, the court has repeatedly stressed that it will not involve itself in discretionary military promotions. *See, e.g., Doggett* v. *United States*, 207 Ct. Cl. 478 (1975); *Yee* v. *United States*, 206 Ct. Cl. 388, 399, 512 F. 2d 1383, 1388 (1975); *Abruzzo* v. *United States*, 206 Ct. Cl. 731, 738, 513 F. 2d 608, 611–12 (1975); *Boyd* v. *United States*, 207 Ct. Cl. 1 (1975); *Brenner* v. *United States*, 202 Ct. Cl. 678, 693–94, 701 (1973), *cert. denied*, 419 U.S. 831 (1974); *Cooper* v. *United States*, 203 Ct. Cl. 300, 303–04 (1973); *Roseman* v. *United States*,

207 Ct. Cl. 998 (1975); *Barnum* v. *United States*, 207 Ct. Cl. 1024 (1975). Plaintiff's promotion to major would be in this discretionary category. If there could ever be an abuse of discretion (in failing to make such a promotion) so great that it amounted to a deprivation of a legal right, that situation would be so rare that the claimant should have the initial burden of alleging and offering to show enough facts and circumstances to make at least a *prima facie* case of that type. That has not been done here in any respect. Accordingly, the defendant's motion to dismiss is granted with respect to this aspect of the claim and the petition is dismissed insofar as it seeks pay as a major and placement in that position.

"IT IS THEREFORE ORDERED that defendant's motion to dismiss is denied with respect to plaintiff's claim for backpay and reinstatement as a captain, without prejudice to the filing of a motion for summary judgment or other means of testing whether the Air Force acted improperly or abused its discretion in passing plaintiff over for selection for promotion.

"IT IS FURTHER ORDERED that defendant's motion to dismiss is granted with respect to plaintiff's claim for promotion to major and the petition is dismissed insofar as it seeks pay as a major and placement in that position."

Plaintiff's motion for reconsideration as to that portion of plaintiff's petition relating to pay as a major and placement in that position was denied March 26, 1976.

No. 233–75. JANUARY 30, 1976

Brian Eric Flescher

Military pay; limitation of actions; administrative review proceedings.—On January 30, 1976 the court issued the following order:

Before DAVIS, *Judge*, Presiding, NICHOLS and KASHIWA, *Judges*.

"Plaintiff, a former member of the regular Air Force, was convicted by General Court Martial on August 14–15, 1968, of violating Article 134 of the Uniform Code of Military

Justice, with a specification of Negligent Homicide. The conviction was followed by automatic review by the Judge Advocate General under Article 69 in 1968 and by plaintiff's honorable discharge from the Air Force on December 30, 1968.

"Plaintiff then again appealed the conviction to the office of the Judge Advocate General, pursuant to the third sentence of 10 U.S.C. § 869 (1970). The appeal was denied in April, 1970. Subsequent appeals to the military corrections board pursuant to 10 U.S.C. § 1552 (1970) were rejected in August, 1970; November, 1971; April, 1972; and October, 1973.

"Plaintiff's petition in this court was filed on July 11, 1975. Plaintiff alleges that his Court Martial conviction was "arbitrary, capricious, and so grossly erroneous as to imply a judgment based upon bad faith." He seeks reinstatement and recovery of "all back pay and allowances" which he has not received as a result of his conviction and discharge.

"Plaintiff's claim accrued, at the latest, six and one-half years prior to the filing of the petition when he was discharged. Plaintiff's 1970 appeal to the office of the Judge Advocate General pursuant to 10 U.S.C. § 869 (1970) does not toll the six-year statute of limitations of 28 U.S.C. § 2501 (1970). He had already had an automatic appeal to that office in 1968 and this was a second, permissive appeal. There is no language in § 869 which requires that such an appeal be taken within a certain time. It would controvert the statute of limitations to allow it to be tolled indefinitely by a plaintiff's inaction in pursuing permissive administrative remedy. In *Artis* v. *United States*, 205 Ct. Cl. 732, 506 F. 2d 1387 (1974), the plaintiff did not have the automatic appeal to the Judge Advocate General which was available to the present plaintiff in 1968. Therefore, because of the expiration of the limitations period,

"IT IS ORDERED that defendant's motion for summary judgment is granted and plaintiff's cross motion for summary judgment is denied. Plaintiff's petition is dismissed."

Plaintiff's motion under Rule 151 was denied March 26, 1976.

JUDGMENT ORDERS

GLOBAL VAN LINES, INC. V. THE UNITED STATES

No. 126–69

On November 7, 1975 the court ordered that judgment be entered for plaintiff in the sum of $12,040.00. The judgment in this case is the first of 894 to come in the so-called "household goods" cases. Future judgments will not be included in this or following volumes. This judgment and those to follow are based on court opinions in *Global Van Lines, Inc.* v. *United States*, 197 Ct. Cl. 575, 456 F. 2d 717 (1972) and *Trans Ocean Van Service* v. *United States*, 192 Ct. Cl. 75, 426 F. 2d 329 (1971); 200 Ct. Cl. 122, 470 F. 2d 604 (1972) together with a stipulation for settlement filed in Global Van Lines, Inc., Nos. 259–65 and 355–65.

KEYDATA CORPORATION V. THE UNITED STATES

No. 299–72

[205 Ct. Cl. 467, 504 F. 2d 1115]

Pursuant to a stipulation of the parties filed November 4, 1975 providing for settlement of plaintiff's claim, the court on November 14, 1975 entered judgment for plaintiff in the gross amount of $15,000. Plaintiff waived, abandoned and released any and all claims set forth in the petition not heretofore dismissed by the court's decision of October 23, 1974.

KARL F. KELLERMAN V. THE UNITED STATES

No. 128–73

[205 Ct. Cl. 484, 504 F. 2d 1128]

On December 12, 1975 the court ordered that judgment be entered for plaintiff in the sum of $18,577.95, of which

$1,120.45 should be credited to plaintiff's Civil Service Retirement Fund Account and $110.40 should be credited to plaintiff's Federal Employee's Group Life Insurance Account, and the balance, or $17,347 should be paid to plaintiff.

CONTRA COSTA COUNTY FLOOD CONTROL AND WATER CONSERVATION DISTRICT V. THE UNITED STATES

No. 392–73

[206 Ct. Cl. 413, 512 F. 2d 1094]

On December 19, 1975 the court ordered that judgment be entered for plaintiff in the sum of $30,000.00.

KNAPP KING-SIZE CORP., AND KNAPP BROTHERS SHOE MANUFACTURING CORP. V. THE UNITED STATES

Nos. 9–73 and 203–73

[208 Ct. Cl. 533, 527 F. 2d 1392]

On December 19, 1975 the court ordered that judgment be entered for plaintiffs in the sums of $622,123.79 ($488,533.36 in tax and $133,590.43 in assessed interest) for the year ended December 31, 1967, and $13,731.98 ($11,441.75 in tax and $2,290.23 in assessed interest) for the year ended December 31, 1968, plus statutory interest thereon.

AMAX RESOURCE RECOVERY SYSTEMS, INC. V. THE UNITED STATES

No. 261–69

[206 Ct. Cl. 756, 514 F. 2d 1041]

On January 23, 1976 the court ordered that judgment be entered for plaintiff in the sum of $60,000.00.

ROBERT C. BRAY V. THE UNITED STATES

No. 182–68

[207 Ct. Cl. 60, 515 F. 2d 1383]

On January 30, 1976 the court ordered that judgment be entered for plaintiff in the sum of $2,528.54.

The court further ordered that defendant, acting through the Secretary of the Air Force, shall take actions to expunge from its records documents relative to plaintiff's invalid dismissal and to correct plaintiff's official military records, as set forth in the order.

REPORT OF DECISIONS
OF
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IN COURT OF CLAIMS CASES

Action was taken by the United States Supreme Court on the parties' petitions for writs of certiorari as follows:

Petitioners	Ct. Cl.	F. 2d	Supreme Court Denied
Rebecca Bibbs No. 202–74	206:896	----------	Nov. 17, 1975 423 U.S. 985
Donald H. Wood No. 192–73	207:948	----------	Dec. 1, 1975 423 U.S. 994
Sioux Nation of Indians App. 16–74	207:234	518:1298	Dec. 8, 1975 423 U.S. 1016
Sac & Fox Tribe of Oklahoma			
App. 7–74	206:897	----------	Dec. 8, 1975
App. 9–74	206:898		423 U.S. 1016
James Strong, et al Pottawatomie Tribe; Hannahville Indian Community; App. 1–74	207:254	518:556	Dec. 8, 1975 423 U.S. 1015
Hugh D. Jascourt No. 180–74	207:955	----------	Dec. 15, 1975 423 U.S. 1032
Lois H. Mitchell No. 16–74	207:981	----------	Jan. 12, 1976 423 U.S. 1049
Grace K. McFarland No. 746–71	207:38	517:938	Jan. 12, 1976 423 U.S. 1049
Emil W. Kaeserman No. 292–69	207:983	----------	Jan. 12, 1976 423 U.S. 1050
Albert H. Carter No. 127–66	206:61 207:316	509:1150 518:1199	Jan. 19, 1976 423 U.S. 1076

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